

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

REPORT OF ASSOCIATION EXAMINATION
OF
SOUTHERN UNITED FIRE INSURANCE COMPANY
Mobile, Alabama

as of
June 30, 2002

Participation:
Alabama

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STATE OF ALABAMA

COUNTY OF MONTGOMERY

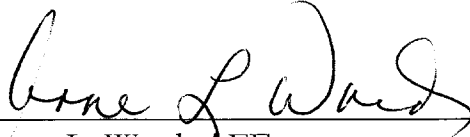
Anne L. Ward, being first duly sworn, upon her oath deposes and says:

THAT she is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

THAT an examination was made of the affairs and financial condition of *SOUTHERN UNITED FIRE INSURANCE COMPANY*, for the period from January 1, 1998 through June 30, 2002;

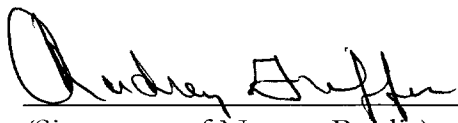
THAT the following 89 pages constitute the report to the Commissioner of Insurance of the State of Alabama; and

THAT the statements, exhibits and data therein contained are true and correct to the best of her knowledge and belief.

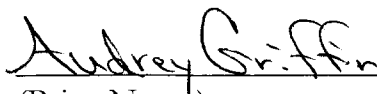


Anne L. Ward, AFE
(Examiner-in-Charge)

Subscribed and sworn to before the undersigned authority this 26th day of January 2004.



(Signature of Notary Public)

 Notary Public
(Print Name)
in and for the State of Alabama

My commission expires 11/2/05



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
FINANCIAL/EXAMINATION DIVISION

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Mobile, Alabama
January 26, 2004

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COMMISSIONER

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Honorable Walter A. Bell
Commissioner of Insurance
State of Alabama, Department of Insurance
201 Monroe Street, Suite 1700
Montgomery, Alabama 36130-3351

Dear Commissioners:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, a full scope financial and market conduct examination as of June 30, 2002, has been made of the affairs and financial condition of

SOUTHERN UNITED FIRE INSURANCE COMPANY

at its home office located at One Southern Way, Mobile, Alabama 36619. The report of examination is submitted herewith.

Where the description "Company" or "SUFI" appears herein, without qualification, it will be understood to indicate *Southern United Fire Insurance Company*.

SCOPE OF EXAMINATION

A full scope financial and market conduct examination was authorized pursuant to the instructions of the Alabama Insurance Commissioner and in accordance with the statutory requirements of the *Alabama Insurance Code* and the regulations and bulletins of the State of Alabama, Department of Insurance (ALDOI); in accordance with the applicable guidelines and procedures promulgated by the National Association of Insurance Commissioners (NAIC); and in accordance with generally accepted examination standards.

The Company was last examined for the period ended March 31, 2001; the examination was limited in scope and reported on operational deficiencies with respect to specific inadequacies first documented by the Consumer Division of the ALDOI. That division had received a substantial increase in the number of complaints against the Company, which raised concerns about the Company's payment practices as cited in ALA. CODE § 27-12-24(1) (1975). The last statutory examination was for the two-year period ended December 31, 1997. The current examination was for the two-year period ended December 31, 1997. The current examination covers the period from January 1, 1998 through June 30, 2002. All examinations were conducted by examiners from the ALDOI, and represented the NAIC's Southeastern Zone.

The examination included a general review of the Company's operations, administrative practices, and compliance with statutes and regulations. Corporate records were inspected. Income and disbursement items for selected periods were tested. Assets were verified and valued, and all known liabilities were established or estimated as of June 30, 2002, as shown in the financial statements contained herein. However, the discussion of assets and liabilities contained in this report has been confined to those items which resulted in a change to the financial statements, or which indicated a violation of the *Alabama Insurance Code* and the ALDOI's rules and regulations or other insurance laws or rules, or which were deemed to require comments and/or recommendations.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attests to have valid title to all assets and to the nonexistence of unrecorded liabilities as of June 30, 2002. A signed letter of representation was also obtained at the conclusion of the examination whereby management represented that, through the date of this examination report, complete disclosure was made to the examiners regarding asset and liability valuation, financial position of the Company, and contingent liabilities. An office copy of the Company's filed *Quarterly Statement as of June 30, 2002*, was compared with or reconciled to account balances with respect to ledger items.

The market conduct phase of the examination consisted of a review of the Company's territory, plan of operation, complaint handling, marketing and sales, producer licensing, policyholder service, underwriting and rating, claims, and privacy policies and practices. Emphasis was placed on claims payment practices and policyholder complaints.

It was noted that the Company did not provide all requested information to the examiners in a timely manner in accordance with ALDOI *Regulation No. 118*. The records in question were related to, but were not limited to, the following items:

- Numerous electronic data files, including descriptions of codes and other fields.
- Various data sets, including cash disbursements/receipts, unearned premiums, in-force listings, paid claim history.
- Supporting documentation concerning bond acquisitions, common stocks, cash and short-term investments, premiums and agents' balances, losses and loss adjustment expenses, accrual for expenses.
- Responses from attorney firms retained by the Company in reference to pending litigation.

Details of the noted problems may be found elsewhere in this report under the specific captions to which they pertain.

ORGANIZATION AND HISTORY

The Company was incorporated on May 14, 1963, under the laws of the State of Alabama and began operations on October 28, 1963, with \$100,000 capital and \$100,000 paid in surplus provided from the sale of 100,000 shares of \$1 par value common stock for a price of \$2 per share. From the time of incorporation until 1986, the Company was a wholly owned subsidiary of Southern United Life Insurance Company (SULIC), Montgomery, Alabama. In 1986, SULIC was obtained by Mutual Savings Life Insurance Company (MSLIC) and relocated to Decatur, Alabama. In April of 1989, the Company was purchased by Southern United Holding Company, Inc. (SUH) and moved to Mobile, Alabama. Prior to the sale, most of the Company's business was assumed by Mutual Savings Fire Insurance Company, a subsidiary of MSLIC. In January 1998, Kingsway Financial Services, Inc. (Kingsway), Mississauga, Ontario, Canada, through Kingsway of America, Inc. (KAI), acquired SUH, the Company's parent. Approval of this transaction was given by the ALDOI on January 16, 1998.

During 1998, the Company established a wholly owned subsidiary, Southern United General Agency of Texas, Inc. (SUGAT).

SUH and the Company are presently based in Mobile, Alabama, and are engaged in the sale of property and casualty insurance products throughout the Southeastern United States.

Capital changes since the Company's incorporation were as follows:

July 9, 1979	Amendment increased the par value of the common shares from \$1 to \$5 per share. Paid up capital was thereby increased to \$500,000, represented by 100,000 shares authorized, issued and outstanding.
June 30, 1994	Amendment increased the par value of the common shares from \$5 to \$15 per share. Paid up capital was thereby increased to \$1,500,000, represented by 100,000 shares authorized, issued and outstanding.
December 30, 1996	A \$296,250 surplus note, which was originally issued on December 31, 1991, was restated and approved by the ALDOI.
December 30, 1996	Two surplus notes, totaling \$2,625,000, were approved by the ALDOI.
December 31, 1997	SUH contributed \$3,875,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$5,071,200 at year-end 1997.
December 31, 1998	SUH contributed \$3,995,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$9,066,200 at year-end 1998.
December 31, 2000	SUH contributed \$700,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$9,766,200 at year-end 2000.
June 12, 2001	Kingsway contributed \$1,500,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$11,266,200.

July 20, 2001	Kingsway contributed \$2,000,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$13,266,200.
December 21, 2001	Kingsway contributed \$1,000,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$14,266,200 at year-end 2001.
May 5, 2002	SUH contributed \$1,000,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$15,266,200.
May 31, 2002	Kingsway contributed \$2,000,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$17,266,200.
June 5, 2002	Kingsway contributed \$2,000,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$19,266,200.
June 28, 2002	SUH contributed \$1,000,000 additional paid in capital, thereby increasing <i>Gross paid in and contributed surplus</i> to \$20,266,200 at quarter-end June 30, 2002.

Detailed information on contributions received by the Company since the previous examination may be found under “Note 17 – Gross paid in and contributed surplus” of the NOTES TO FINANCIAL STATEMENTS. Subsequent to the examination period, Kingsway made six additional contributions totaling \$15,250,000. Details concerning these matters may be found under the *Capital Contributions* caption in the SUBSEQUENT EVENTS section of this report.

At the June 30, 2002 examination date, the Company’s Quarterly Statement reflected outstanding capital stock totaling \$1,500,000, consisting of 100,000 shares of \$15 par value *Common stock*; three *Surplus notes* totaling \$2,921,250; *Gross paid in and contributed surplus* of \$20,766,200; and \$(14,082,057) in *Unassigned funds (surplus)*.

MANAGEMENT AND CONTROL

Stockholders

The Company was a stock corporation with ultimate control vested in its stockholders. At June 30, 2002, one hundred percent (100%) of the Company's issued and outstanding common stock was owned by SUH, which was a member of Kingsway Financial Services, Inc., a Canadian corporation.

Board of Directors

The By-Laws of the Company provided that its business and affairs shall be managed by a Board of Directors. The *Amended and Restated By-Laws*, adopted on July 26, 1999, set the number of directors at "not...less than three (3) nor more than fifteen (15)..."

The members of the Board of Directors that were serving at June 30, 2002, were as follows:

<u>Name/Residence</u>	<u>Principal Occupation</u>
William Shaun Jackson Mississauga, Ontario, Canada	Vice President, and Chief Financial Officer Kingsway Financial Services, Inc.
Charles Dixie Jordan Montgomery, Alabama	Retired
William Gabriel Star Mississauga, Ontario, Canada	President, and Chief Executive Officer Kingsway Financial Services, Inc.
Craig Alan Lochner* Mobile, Alabama	President, and Chief Executive Officer Southern United Fire Insurance Company
James Roger Zuhlke Schaumburg, Illinois	President, and Chief Executive Officer Kingsway America, Inc.

* Resigned November 14, 2002 – replaced by Richard Day Murray as CEO

Officers

Officers elected by the Board of Directors and serving at June 30, 2002, were as follows:

<u>Name</u>	<u>Title</u>
Craig Alan Lochner ¹	President
Alfred Lee Trovinger ²	Secretary and Vice President
Anthony Joseph Bowab ³	Treasurer
Robert Patrick Heffner, Jr. ⁴	Vice President
Richard Wesley Bird	Vice President

¹ Resigned November 14, 2002 – replaced by William Gabriel Star

² Resigned November 14, 2002 – replaced by Richard Wesley Bird

³ Resigned January 3, 2003 – replaced by Carrie Renee Harper

⁴ Resigned January 24, 2003 – replaced by Richard Day Murray

Also see the SUBSEQUENT EVENTS section of this report for additional details concerning the Company's appointed/elected directors and officers.

CORPORATE RECORDS

The Company's Certificate of Incorporation, By-Laws and related amendments were inspected and found to provide for the operation of the Company in accordance with usual corporate practices.

On July 26, 1999, pursuant to Sections 10-2B-10.07 and 10-2B-10.20 of the *Alabama Business Corporations Act*, the Company amended and restated its Articles of Incorporation and By-Laws. The documents were filed appropriately with the ALDOI.

There were no other changes to the Company's corporate records during the examination period.

HOLDING COMPANY AND AFFILIATE MATTERS

Holding Company Registration

The Company was subject to the *Alabama Insurance Holding Company Regulatory Act*, as defined in ALA. CODE § 27-29-1 (1975). In connection therewith, the Company was registered with the ALDOI as Registrant of an Insurance Holding Company System. Appropriate filings required under the Holding Company Act were made from time to time by the Company. A review of certain Company's filings during the period under examination indicated that all required filings were not made in

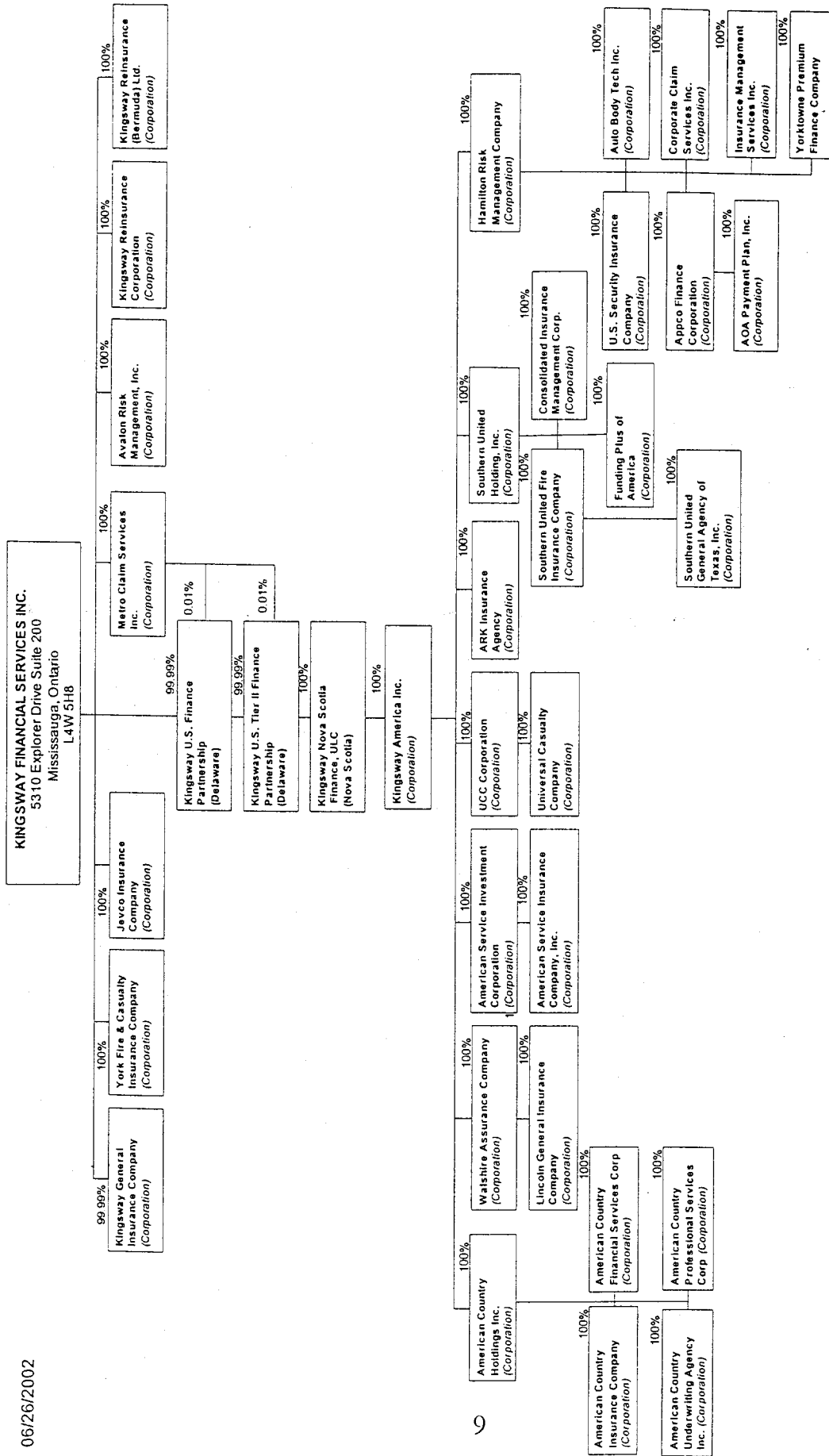
accordance with the aforementioned section of the *Alabama Insurance Code* and ALDOI *Regulation No. 55*.

Organizational Chart

The following chart presents the identities of and interrelationships among all affiliated persons within the Insurance Holding Company System at June 30, 2002:

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06/26/2002



Transactions and Agreements with Affiliates

Management Services and Facilities Agreement:

A *Management Services and Facilities Agreement* was entered into by and between the Company and Consolidated Insurance Management Corporation (CIMC). The Company and CIMC are affiliated companies in a group of wholly owned subsidiaries of Kingsway Financial Services Inc., a Canadian insurance and financial services holding company.

Although Company records indicated that an initial contract was executed in 1989, ALDOI files did not corroborate that this or any other management arrangement between the referenced companies had been received by the ALDOI. While previous examination reports discussed the existence of a management agreement, no evidence could be located that substantiated its submission to or approval/disapproval by the Commissioner. Concerning transactions between an insurer and any person in its holding company system, ALA. CODE § 27-29-5 (b) (1975), states, in pertinent part, that an agreement:

“...may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto...and the commissioner has not disapproved it within that period.”

The Company asserts that a revised agreement was filed with the ALDOI on November 17, 1999, “to reflect current cost and service levels within the organization.” Evidently, this version was utilized during the examination period; however, the provisions do not comply with the requirements of the *Alabama Insurance Code*. The term of this agreement was three years commencing on January 1, 2000, and terminating on December 31, 2002. The agreement would automatically renew for each subsequent three year period unless written notice was provided by either party sixty days prior to expiration.

The above parties hereto agreed as follows:

- The Company agreed to reimburse CIMC for commission expenses paid to producing agents. In addition, the Company will pay CIMC a percentage of each calendar month’s gross direct and assumed written premium, net of cancellations, a sliding servicing fee based on the following written premiums:

MONTHLY GROSS WRITTEN PREMIUM NET OF CANCELLATION	SERVICING FEES
\$0.00 up to \$4,000,000.00	21.0%
\$4,000,000.01 up to \$8,000,000.00	18.0%
\$8,000,000.01 and over	16.0%

- CIMC agreed to provide the Company at no additional cost the following additional services reasonably related thereto:
 - a. accounting and financial services
 - b. electronic data processing services
 - c. sales and marketing services including the payment to agents of all commissions due agents
 - d. employment of personnel necessary to properly enable the insurance Company to function
 - e. claims management and adjustment services
 - f. telephone services
 - g. postage.
- CIMC agreed to provide the Company at no additional cost the following facilities and any additional facilities reasonably related thereto:
 - a. office space
 - b. books, periodicals and subscriptions to trade publications
 - c. office furniture and equipment
 - d. casualty insurance coverage
 - e. general purpose supplies and printed materials (including supplies and printed materials specially related to Company's business, such as policy and claims forms).

On April 22, 2002, in response to recommendations made in the *Report of Limited Scope Examination* as of March 31, 2001, and in accordance with ALA. CODE § 27-29-5 (1975), and ALDOI *Regulation No. 55*, the Company filed a *Form D – Prior Notice of a Transaction*, concerning “Addendum 1 to the Management Services and Facilities Agreement.” On May 23, 2002, based on representations made in that Form D filing, this amendment was disapproved based upon the method of calculating the fees. The ALDOI permits reimbursement based upon actual cost plus any overhead to provide services, not on a percentage of premiums received. Apparently, the agreement has been amended several times, resubmitted to the ALDOI and rejected each time for various reasons.

It was noted that under the agreement utilized, the Company paid CIMC for management, services and expenses, which included commissions, during the five-year

examination period. Because the *Management Services and Facilities Agreement* did not comply with the provisions of the relevant sections of the *Alabama Insurance Code*, payment of management fees, etc., was not appropriate.

Item #10.B., of the Company's 2001 Annual Statement *Notes to Financial Statements* indicated that commissions were paid to CIMC as managing agent. ALA. CODE § 27-6A-2(3)c.3 (1975) stipulates, in pertinent part, that:

“An underwriting manager, who, pursuant to contract, manages all or part of the insurance operations of the insurer, is under the common control with the insurer, subject to the Alabama Insurance Holding Company System Regulatory Act, chapter 29, commencing with section 27-29-1, of this title, **and whose compensation is not based on the volume of premiums written.**” [emphasis added]

Management indicated that “CIMC does not have an MGA [managing general agent] license in effect as of June 30, 2002,” and “no MGA contract is in force between SUFI and CIMC.” The Company has been “operating under the belief that the relationship of CIMC and SUFI falls under the Holding Company Statutes and CIMC has been considered an underwriting manager under the definition of an MGA (27-6A-2c3).” This examination has determined that the Company has been acting in the capacity of an MGA, as defined by ALA. CODE § 27-6A-2 (1975), and does not meet the requirements for exemption as the compensation schedule, discussed previously in this section, was based on the volume of premiums written (commission).

ALA. CODE § 27-6A-4 (1975) requires a written MGA contract between the Company and CIMC. In addition, CIMC was not licensed as an MGA as required by ALA. CODE § 27-6A-3 (1975), nor as any other person as defined in ALA. CODE § 27-7-1 (1975). CIMC was not appointed as a producer in accordance with ALA. CODE § 27-7-4(b) (1975). The Company reported substantial earned premiums produced by CIMC during the five-year examination period. Consequently, the Company would be contingently liable for a fine of up to three times the premium received from CIMC, in accordance with Section 27-7-4(a) of the *Alabama Insurance Code*.

It should also be noted that ALA. CODE § 27-7-4.1(a) (1975) states, in pertinent part, that:

“No insurer or producer shall pay, directly or indirectly, any commission or other valuable consideration to any person for services as a producer or service representative within this state unless the person holds a

current valid license as a producer or service representative...”

Item (b) of that statute stipulates that an insurer or producer violating said section “shall be liable for a fine in an amount of up to three times the amount of the commission paid.” Documentation evidencing commissions paid to CIMC was provided by the Company in the *GL Transaction Report* as of June 30, 2002; accordingly, the Company would be contingently liable for a fine of as much as three times the commission paid.

The Company and the ALDOI have been working together in order to insure that the agreement is in accordance with ALA. CODE § 27-29-5 (1975). In order to avoid administrative and financial penalties provided for in ALA. CODE § 27-7-4.1(a) and (b) (1975), the Company submitted a revised agreement to the ALDOI, which, in the opinion of the ALDOI’s Legal Division, appears to comply with the *Alabama Insurance Code*. The agreement is currently under review by the Commissioner and subject to his approval. At the date of this report, however, the Company had not obtained final approval of its management agreement.

Subsequent to the examination date, Company management indicated that the affiliated CIMC would be dissolved; consequently, SUFI intends to manage its own business and services. Should this come into fruition, the need for a management agreement would thereby be eliminated.

Tax Allocation Agreement:

On February 2, 1999, a tax allocation agreement was executed by Kingsway America, Inc. (“Parent”) with eighteen members of the affiliated group (Subsidiaries), including the Company, being parties to the agreement. Various addenda were made to the original agreement during the year, which bound ten more members of the affiliated group to the agreement.

The affiliated group of companies subject to the agreement would be required to file a consolidated income tax return for subsequent taxable periods unless the Parent and the Subsidiaries agreed in writing to terminate the agreement. Notwithstanding such termination, this agreement would continue in effect with respect to any payment or refunds due for all taxable periods prior to termination.

The Parent and Subsidiaries, both parties to the agreement, agreed as follows:

- The U.S. consolidated tax return shall be filed by the Parent for the taxable year December 31, 1998, and each subsequent taxable period. Each Subsidiary shall

execute and file such consent, elections, and other documents that may be required or appropriate for the proper filing of such returns.

- The parties to the agreement agreed that the consolidated tax liability for each year, determined in accordance with Income Tax Regulation 1.1502-2, shall be apportioned among them in accordance with the provisions of Income tax regulation 1.1502-33(d)(3) (Percentage Method). For the purposes of this agreement, the consolidated tax liability shall include any liability for alternative minimum tax.
- Payment of the consolidated tax liability for a taxable period would include estimated tax installments due for such taxable period. The subsidiaries would pay Parent its share within thirty days of receiving notice of such payment from Parent. Any payments made by the subsidiaries that are credited against the consolidated tax liability shall be included in determining the payments due from subsidiaries. Any overpayment of estimated tax should be refunded to the subsidiaries within thirty days.
- If, for any taxable period, the separate return liability of any member of the affiliated group, including the Parent, exceeds the consolidated tax liability as a result of any excess losses or tax credits, the Parent shall pay to each such member its allocable portion of such excess amount within thirty days after the date of the consolidated return for such period.
- If the consolidated tax liability is adjusted for any taxable period, then the liability of each member will be recomputed to give effect to such adjustments. In the case of a refund, the parent would make payments to each subsidiary within thirty days.
- If, during a consolidated return period, the Parent or any Subsidiary acquires or organizes another corporation that is required to be included in the consolidated return, that corporation would join in and be bound by this agreement.
- This agreement would be binding upon and inure to the benefit of any successor, whether by statutory merger, acquisition of assets, or otherwise, to any of the parties hereto, to the same extent as if the successor had been an original party to the agreement.

The Company provided no evidence that prior approval of the agreement was filed in accordance with ALDOI *Regulation No. 55*. The Company furnished various addenda, the most recent of which was dated June 1999. Section 15 of the aforementioned regulation, and ALA. CODE § 27-29-4(d) (1975) require changes or additions to be reported on a Form B amendment within 15 days after the end of the month in which the transactions occur. ALA. CODE § 27-29-5(b) (1975) also states that transactions with affiliated persons “may not be entered into unless the insurer

has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto...and the commissioner has not disapproved it within that period.” Consequently, the Company should not have been operating under this arrangement until such time that the agreement was submitted with Form D for approval from the Commissioner. Based on representations made in a subsequent Form D filing, the agreement was approved by the ALDOI on May 23, 2002.

Reinsurance Agreements:

Reinsurance agreements with affiliated companies are discussed in detail in the REINSURANCE section, elsewhere in this report.

FIDELITY BONDS AND OTHER INSURANCE

At June 30, 2002, the Company was a named insured under a Financial Institution Bond, issued by the London Guarantee Insurance Company, Toronto, Ontario. The single loss limit liability of the bond was \$1,500,000, with a single loss deductible of \$75,000, which exceeded the minimum requirements for fidelity coverage as defined by NAIC guidelines.

The bond insured the Company against any loss through any dishonest or fraudulent act committed by an employee acting alone or in collusion with others. The dishonest or fraudulent acts must be committed by the employee with the manifest intent to cause the insured to sustain such loss, and to obtain financial benefit in the normal course of employment.

In addition to the aforementioned financial institution bond, two insurance policies were issued to the Company, covering the following:

- *Commercial Property Coverage*
 - Building
 - Business Personnel Property
 - Business Income Extra Expense
 - Business income indemnity
- *Workers Compensation (effective date: March 1, 2002)*
 - Bodily Injury by Accident
 - Bodily Injury by Disease

The types of coverages and the maximum limits indicated for each occurrence appears

to have been sufficient to cover the Company from the liabilities arising from employees injuries and other hazards to which it might be exposed.

During the review of *Real estate*, the examiners could not determine if the Company's office building was sufficiently insured at June 30, 2002, to cover the replacement cost of the building. Documentation dated subsequent to that period was provided by the Company, and the amount was deemed to be adequate.

The coverages and limits carried by the Company were assessed during the course of the examination and appeared to realistically protect the Company's interests at the examination date.

EMPLOYEE AND AGENTS WELFARE

All personnel were employees of CIMC, which provided services to the Company under the terms of the previously mentioned *Management Services and Facilities Agreement*. As a result of this agreement, the Company did not have a retirement plan, deferred compensation and/or other benefit plan.

SPECIAL DEPOSITS

In order to comply with the statutory requirements for doing business in the various jurisdictions in which it was licensed, the Company had the following securities on deposit with state authorities at the June 30, 2000 examination date:

<u>Description</u>	<u>Par Value</u>	<u>Book or Statement Value</u>	<u>Market Value</u>
<i>Georgia</i>			
Money Market Account, Wachovia Bank, Atlanta, GA	\$ 85,259	\$ 85,259	\$ 85,259
<i>Total-Georgia</i>	\$ 85,259	\$ 85,259	\$ 85,259
<i>Louisiana</i>			
Union Planters Bank CD, 4.10%, due 06/27/2003	\$ 20,000	\$ 20,000	\$ 20,000
Union Planters Bank CD, 5.70%, due 09/17/2002	50,000	50,000	50,000
<i>Total-Louisiana</i>	\$ 70,000	\$ 70,000	\$ 70,000
<i>South Carolina</i>			
Colonial Bank CD, 6.05%, due 03/11/2003	\$ 65,000	\$ 65,000	\$ 65,000
Colonial Bank CD, 6.10%, due 12/13/2003	35,000	35,000	35,000
Compass Bank CD, 6.60%, due 12/08/2003	100,000	100,000	100,000

Delta Premier Cr. Union CD, 6.35%, due 12/15/2002	100,000	100,000	100,000
Regions Bank CD, 3.40%, due 06/10/2004	100,000	100,000	100,000
Whitney Bank CD, 5.00%, due 03/11/2004	60,000	60,000	60,000
Whitney Bank CD, 5.40%, due 11/14/2002	40,000	40,000	40,000
US Treasury, 5.50%, due 05/15/2009	<u>1,600,000</u>	<u>1,624,716</u>	<u>1,693,008</u>
<i>Total-South Carolina</i>	<u>\$ 2,100,000</u>	<u>\$ 2,124,716</u>	<u>\$ 2,193,008</u>
Total-Not All Policyholders	<u>\$ 2,255,259</u>	<u>\$ 2,279,975</u>	<u>\$ 2,348,267</u>
<i>Alabama</i>			
Colonial Bank CD, 4.65%, due 04/28/2003	\$ 50,000	\$ 50,000	\$ 50,000
Colonial Bank CD, 4.65%, due 05/19/2003	50,000	50,000	50,000
Whitney Bank CD, 3.80%, due 07/15/2003	55,000	55,000	55,000
Bond, New Orleans, LA Sewer, SVC Rev MBIA, 4.4%	200,000	201,992	207,032
Bond, New Orleans, LA Sewer, SVC Rev MBIA, 4.5%	350,000	353,475	361,778
Bond, Baton Rouge, LA Sales & Use Tax Ref Pub Imp	<u>700,000</u>	<u>735,523</u>	<u>759,290</u>
<i>Total-All Policyholders</i>	<u>\$ 1,405,000</u>	<u>\$ 1,445,990</u>	<u>\$ 1,483,100</u>
TOTALS	<u>\$ 3,660,259</u>	<u>\$ 3,725,965</u>	<u>\$ 3,831,367</u>

Confirmation of these deposits was obtained directly from the respective custodians.

FINANCIAL CONDITION/GROWTH OF THE COMPANY

The following table sets forth the significant items indicating growth and financial condition of the Company for the period under review:

<u>Period Ending</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital and Surplus</u>	<u>Direct Premiums Written</u>	<u>Direct Losses Incurred</u>
06/30/2002*	\$26,597,088	\$28,207,925	\$(1,610,837)	\$35,561,693	\$23,111,708
06/30/2001	24,609,493	17,199,313	7,410,180	35,455,826	16,094,148
03/31/2001*	21,236,892	23,516,077	(2,279,185)	22,174,789	6,990,019
03/31/2000	14,968,767	7,356,213	7,612,554	6,334,613	3,319,384
12/31/2000	18,552,394	12,283,215	6,269,179	32,409,550	14,863,168
12/31/1999	14,364,116	6,561,120	7,802,996	29,267,947	21,053,212
12/31/1998	18,040,281	9,675,404	8,364,877	52,915,752	50,141,853
12/31/1997*	19,269,739	14,919,208	4,350,531	72,072,393	62,477,046

* Per examination. Amounts for the remaining years were obtained from Company copies of filed Annual and Quarterly Statements.

MARKET CONDUCT ACTIVITIES

Territory

At the examination date, the Company was licensed to transact business in the following seven states:

Alabama	Kansas	Mississippi	Texas
Georgia	Louisiana	South Carolina	

The Certificates of Authority for the respective jurisdictions were inspected for the period under review and found to be in order. Authorized lines were compared with the lines of business shown in the *Underwriting and Investment Exhibits* of the 2001 Annual Statement, and no discrepancies were noted.

No license applications were pending at June 30, 2002, and at the date of this report.

Plan of Operation

During the examination period, the Company concentrated on underwriting automobile liability and physical damage insurance in the non-standard market, with some surety business. All of the Company's written and assumed premiums were generated by CIMC, a wholly-owned subsidiary of the Company's parent, SUH. The affiliated Funding Plus of America, Inc. (FPA), also a wholly-owned subsidiary of SUH, offered premium financing to the Company's policyholders.

The Company engaged in reinsurance ceded transactions as part of its overall underwriting and risk management strategy. Reinsurance ceded programs included coverages which limited the amount of individual claims to a fixed amount and the amount of claims related to catastrophes. The reinsurance ceded program with Kingsway Reinsurance Corporation, a Barbados domiciled reinsurer and an affiliate, consisted of: (i) a quota share reinsurance contract, ceding 75% for all business up to statutory limits; and (ii) 100% coverage for increased limits coverages.

In 2002, the Company ceased writing business in the State of Louisiana due to market conditions and an inability to achieve rate adequacy. In the states of Alabama, Georgia and Mississippi, the Company has aggressively pursued rate adequacy and agency management to improve loss results.

Treatment of Policyholders and Claimants

Complaint Handling

An inspection of the Company's complaint register was made by the examiners and compared with complaints recorded by the Consumer Division of the ALDOI for the period between April 1, 2001 and June 30, 2002. The Company did not have a manual that outlined its procedures for the handling of complaints. As of January 1, 2002, the Company was using the NAIC format, which included all of the required fields, as recommended by the March 31, 2001 examination.

A total of 26 complaints made against the Company, by consumer direct or filed with the ALDOI, reflected the following:

- 18 - answered complaints
- 1 - open complaints
- 4 - complaints from other states on ALDOI log
- 1 - could not be pulled up in Company's system
- 2 - duplicate entries.

The two duplicated items were eliminated, reducing the ALDOI register to 24. The Company's log contained seven entries, all of which were included on the ALDOI's listing. Because the total population was less than the 48 item sample size dictated by market conduct statistical sampling parameters, the examiners elected to review all 24 complaints.

Complaints were found to be principally due to perceived unsatisfactory settlements of claims or denial of claims. The following exceptions were determined in the review of the Company's complaint handling:

Complaint Handling Standard 1 – All complaints are recorded in the required format on the Company complaint register.

Complaint log and documentation

The review of the complaint logs determined that there were 17 complaints of which the Company had no record. Sixteen were written complaints as defined by the standards in the NAIC Market Conduct Handbook. Company management stated that they could not find these complaints. During the course of the examination, the Company requested and received information for 16 complaints from the ALDOI and has since logged these into its system. Documentation on one item could not be

located by the Consumer Division. The Company did not maintain its documentation and records as required by ALA. CODE § 27-27-29(a) (1975). As of January 1, 2002, the NAIC format has been implemented for recording complaint information. The Company is recording some complaints in the correct format; however, the Company is not recording all complaints against them.

Complaint Handling Standard 2 – The Company has adequate complaint handling procedures in place and communicates such procedures to policyholders.

Complaint procedures manual

The Company did not have procedures in place for the handling of complaints as defined in Complaint Handling Standard 2 of the NAIC Market Conduct Handbook.

Complaint Handling Standard 3 – The Company takes adequate steps to finalize and dispose of the complaint in accordance with applicable statutes, rules and regulations, and contract language.

Complaint documentation

The review indicated that the Company was not keeping all of the documentation needed to determine if the complaints were being fully addressed as defined by Complaint Handling Standard 3 of the NAIC Market Conduct Handbook and ALA. CODE § 27-27-29(a) (1975) for maintenance of records.

Complaint Handling Standard 4 – The time frame within which the Company responds to complaints is in accordance with applicable statutes, rules and regulations.

Resolution of complaints

It was determined that one complaint took over 100 days to resolve. This response time appears to be excessive, considering the average response time for the items reviewed was 45.5 days. The Company has no policies or procedures by which the timeliness of response to complaints can be measured. There are no Alabama statutes or NAIC guidelines stipulating the length of time for handling of complaints. However, the ALDOI has utilized 60 days as timely, which was employed for the purposes of this examination to gauge timeliness. It should be noted that this 100-day complaint has been resolved by the Company.

Subsequent complaints

A review was conducted to determine the Company's compliance with recommendations made in the prior examination, as of March 31, 2001. The examiners previously recommended that the Company keep a complaint log in

accordance with standards in the NAIC Market Conduct Handbook.

There were fifteen complaints that were recorded by the ALDOI subsequent to June 30, 2002. The following was determined:

<u>COMPLAINTS</u>	<u># OF ITEMS RECORDED ON COMPANY LOG</u>	<u># OF ITEMS NOT RECORDED ON COMPANY LOG</u>
Claims	2	6
Underwriting	1	3
Not found	2	0
N/A	<u>1</u>	<u>0</u>
TOTALS	<u>6</u>	<u>9</u>

Of the 15 complaints, six were recorded on the Company's log and nine were not; five were still open as of the date of the review. Consequently, the Company is still not recording and documenting its complaints in accordance with ALA. CODE § 27-27-29(a) (1975), and Complaint Handling standards in the NAIC Market Conduct Handbook.

Policyholder Service

In order to review the Company's policy issuance and cancellation practices, a sample of 48 was selected from the "Insured Requested Cancellation" file. The sample was also used to determine if premium notices were sent on a timely basis as defined by ALA. CODE § 27-23-23 (1975). Insured requested cancellations were reviewed to determine timeliness of handling, as outlined in Policyholder Service Standard 2 of the NAIC Market Conduct Handbook and the Company's Underwriting Procedures Manual (U/W Manual). The examiners determined that insured requested cancellations were handled in a timely manner without excessive paperwork in accordance with the aforementioned standard and manual.

The sample revealed the following exception for insured requested cancellations:

Policyholder Service Standard 1 – Premium notices and billing notices are sent out with an adequate amount of advance notice.

Discrepancies of Cancellation methods

The review determined that the Company was using two different methods of cancellations, short rate and pro rata, for insured requested cancellations during the examination period January 1, 1998 through June 30, 2002. The method defined in

the Company's policy forms stated that the premium refund, if any, would be calculated according to the Company manuals. The Company's U/W Manual stated that the pro rata method of cancellation would be used, and the Company's Alabama Private Passenger Alabama Underwriting Guide (AL U/W Guide) stated that policies will be cancelled short rate at the insured's request. The Company should have corrected its AL U/W Guide to reflect the method used by the Company to process insured requested cancellations to ensure a proper filing of insured requested cancellations with the ALDOI.

Proof of mailing for lien holders

A random sample (48) of "Non-payment Cancellations" was reviewed to determine if the premium finance company and other agencies provided the Company with notices of cancellation. None were found. ALA. CODE § 27-40-11(d) (1975) states that notice must be given to any governmental agency, mortgagee or other third party by the insurer on or before the second business day after it receives the notice of cancellation from the finance company. The Company stated that "Southern United has never required premium finance companies to furnish lien holders' copies of the cancellation notices."

Marketing and Sales

The Company currently markets non-standard automobile insurance in all states in which it is licensed to do business, with the exception of Kansas and Texas. A small amount of motorcycle business is written in Alabama and South Carolina. For market conduct purposes of this examination, only business written in the state of Alabama was reviewed.

CIMC, an MGA, produced all of the Company's business. The agreement with CIMC is discussed in detail in the HOLDING COMPANY AND AFFILIATE MATTERS section of this report under the *Management Services and Facilities Agreement* caption. All of the business was written through independent insurance agencies.

The Company does not have a formal advertising/marketing program. The Company employs marketing representatives to recruit agencies to write business. Approved materials are used by the agencies for advertising purposes. Agencies must get approval for any other advertising from CIMC, per the Producer Agreement signed by each agency.

Business is written by direct bill and agency bill in six-month and twelve-month terms. While the majority of business is direct bill installment premium, the Company does

accept either internal or external premium finance business. Internal premium finance is available through an affiliate, FPA.

The examiners acquired the following training materials from the Company:

- Underwriting guidelines
- Company rating disk
- Applications and Forms.

The following were reviewed on the Internet:

- Passport (Website)
- IVR (Interactive voice response).

There are no state statutes, rules or regulations for marketing and sales which guide insurance companies. According to the NAIC Market Conduct Handbook, the “Company is required to have procedures in place to establish and at all times maintain a system of control over the content, form and method of dissemination of all of its advertisements.”

The Company has an internet website, www.southernunited.com, but it is not used for any mass marketing of its products. The sales materials and policy forms reviewed by the examiners were approved by the Company’s marketing committee and meet the requirements of Marketing and Sales Standard 1 of the NAIC Market Conduct Handbook with the exception of the following:

<p><i>Marketing and Sales Standard 1 – All advertising and sales materials are in compliance with applicable statutes, rules and regulations.</i></p>
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Internet website and advertising materials

The review of the Company’s Internet website and certain advertising materials indicated that the Company did not consistently have its lines of business, or address and phone number displayed. Subsequent to the examination period, the Company revised its website homepage to include all relevant telephone numbers, the physical address and E-mail addresses, etc., so that the information available was more closely aligned with guidelines established in the above captioned standard of the NAIC Market Conduct Handbook.

Compliance with Agents' Licensing Requirements

Producer Licensing

The examiners made an inspection of the Company's records to determine if agencies representing the Company were properly licensed, and the agents within the agencies were duly appointed by the State of Alabama. A register of licensed agents was obtained from the Agents' Licensing Division of the ALDOI and compared to a current list of agents provided by the Company. A review was conducted to determine that persons receiving commissions from the Company were properly licensed to represent the Company. Commissions were paid to the Company's MGA, CIMC, an affiliate, in accordance with the *Management Services and Facilities Agreement*, discussed elsewhere in this report. As was noted under that caption, the MGA was not properly licensed in accordance with ALA. CODE § 27-7-4.1(a) (1975), did not have a written MGA contract in accordance with ALA. CODE § 27-6A-4 (1975), and was, inappropriately, paid commissions based on the volume of premiums written in violation of ALA. CODE § 27-6A-2(3)c.3 (1975). (See the referenced narrative under the HOLDING COMPANY AND AFFILIATE MATTERS heading, beginning on page 7 of this report.).

The Company provided records for 258 active agents writing business in the State of Alabama as of June 30, 2002. The Company did not have a complete list of all producers within the agencies. A comparison of licensing records provided by the Company and those furnished by the ALDOI indicated a number of discrepancies. The following exceptions were noted:

Producer Licensing Standard 1 – *Company records of licensed and appointed producers agree with department of insurance records.*

Producer Licensing Standard 2 – *The producers are properly licensed and appointed in the jurisdiction where the application is taken.*

Producer licenses and appointments

From the 258 agents, a random sampling produced a selection of 48 items to be reviewed. It was determined that the Company was not maintaining producer records as defined by ALA. CODE § 27-27-29 (1975). The Company did not have a way of monitoring agents on a regular basis to assure that they are properly licensed and appointed as specified by ALA. CODE §§ 27-7-4 *License requirement*, and 27-7-30 (1975) *Producer Appointment; Termination of appointment*, and Producer Licensing Standard 2 of the NAIC Market Conduct Handbook.

Agents' commissions

A statistical sample of 48 items was taken from the Company's records of new business written to determine if any agents, not properly licensed or appointed, were receiving commissions. The following exceptions were noted:

The review of the Company list and the ALDOI list of producers determined that there were those producers who were receiving commissions and not properly licensed as required in ALA. CODE §§ 27-7-4(a) *License requirement*, and 27-7-30(a) (1975) *Producer appointment*. There was a total of nine agencies in the sample that were not properly licensed as corporations in accordance with ALA. CODE § 27-7-4(a) (1975).

All 48 agencies in the sample were not appointed as required by ALA. CODE § 27-7-30(a) (1975) *Producer Appointment*, and ALA. CODE § 27-7-29.2 (1975) *Assumed business name*.

Producer Terminations

Producer Licensing Standard 3 – Termination of producers complies with statutes regarding notification to the producer and notification to the state if applicable.

Termination of producers

The examiners obtained an electronic data file listing of agents/agencies terminated by the Company between January 1, 1998 and June 30, 2002. A sample of 48 items was selected; a review of these items determined that the Company only had documentation concerning termination notification sent to the ALDOI for seven of the 48 producers, which is not in accordance with by ALA. CODE § 27-7-30(e) (1975). The Company also had incomplete and incorrect data in its computer system concerning certain producers. The Company had no documentation in the files for notification of termination to the producers within 15 days after the ALDOI was notified, as required by ALA. CODE § 27-7-30.1(a) (1975).

Terminated Producer documentation

A review of the Company's files indicated that the Company was not consistent in its documentation for termination of producers. It was determined that the Company did not have all of the letters of termination in the files or copies of notices sent to the ALDOI, as required in ALA. CODE §§ 27-7-30(e) and 27-7-30.1(a) (1975). Consequently, the Company had not maintained its hard copy or computer data files as required in the ALA. CODE § 27-27-29(a) (1975).

Problem Agents/Agencies

Per instructions from the ALDOI, the examiners inspected certain agent and agency documentation in order to determine if the Company had appropriate procedures in place to substantiate that all agents/agencies were licensed and appointed in accordance with ALA. CODE § 27-7-4 (1975) *License Requirement*, ALA CODE § 27-7-30 *Producer Appointment*, and Producer Licensing Standard 2 of the NAIC Market Conduct Handbook. The review indicated that the Company did not have a method of monitoring agents/agencies on a regular basis to assure the proper licensing and appointment of producers as required by the above mentioned authorities and guidelines.

Underwriting and Rating

Active Policies

The Company writes six-month and twelve-month non-standard private passenger automobile (PPA) liability and physical damage insurance policies for vehicles valued up to \$50,000, and for drivers with up to 15 violation points. Liability limits up to \$100,000/\$300,000 for Bodily Injury and \$50,000 for Property Damage, and deductibles up to \$1,000 for Comprehensive and Collision coverage were available. The Company collects a policy fee on each policy issued or renewed. Motor vehicle reports (MVR) and SR-22 fees were also collected, where applicable.

A sample of 48 policies was selected for review from a population of 10,206 policies in force as of June 30, 2002. There were 12 new business and 36 renewal policies within this sample. The underwriting documentation provided by the Company for the sample was reviewed to determine if the rates charged for the policy coverage were in accordance with filed rates or Company rating plan; if all forms and endorsements forming a part of the contract were listed on the declarations page and had been filed with the ALDOI; if the Company's underwriting practices were unfairly discriminatory; if the Company adheres to the its guidelines in the selection of risks; and if file documentation adequately supported decisions made.

Rating Practices

Underwriting and Rating Standard 1: Rating Practices – The rates charged for the policy coverage are in accordance with filed rates or the company rating plan.

All Alabama PPA rates and rules should be approved by the ALDOI prior to their use in accordance with ALA. CODE §§ 27-2-17, 27-13-4 (1975), ALA. ADMIN. CODE 482-1-123 (2001), and an ALDOI Bulletin, issued March 31, 2001 *Rate Manual Filing*

Requirements (March 31, 2001 Bulletin).

Copies of the Company's independent rate and rule filings in use during the examination period were reviewed to ensure that these filings were legible, complete and stamped approved by the ALDOI evidencing the applicable approval and effective dates. The Company does not maintain rating manuals. The Company's Alabama Underwriting Guidelines, Base Rates, Relativities and Rating Formula that were included in the rate and rule filings submitted to the ALDOI were used to review the sample of Active Policies. Since the Company issued policies by an automated system, the policy premium was rated for policies based on a selection of classes and various territories to verify that the computer was programmed correctly.

The rates charged for the policy coverage did not appear to be in accordance with filed rates or Company rating plan for seven policies within the sample. The incorrect vehicle surcharge points were used for three of these seven policies, the zip code was not listed in zip code/territory pages for two policies, the incorrect territory code was used for one policy, and the incorrect driver surcharge points were used for the remaining policy. Vehicle surcharge points should be assigned based on the filed vehicle surcharge table; territory codes should be assigned based on the zip code as shown in filed zip code/territory pages; and driver surcharge points should be assigned based on the driver points table filed by SUFI, effective February 1, 2001 or February 1, 2002, in accordance with ALA. CODE §§ 27-2-17, and 27-13-4 (1975), ALA. ADMIN. CODE 482-1-123 (2001), and the March 31, 2001 Bulletin.

Revised premium calculations provided for five of the aforementioned seven policies indicated that the insured was overcharged a total of \$222 on four policies and undercharged \$37 on one policy. The policy premium was not affected for the two policies for which zip codes were not listed in the zip code/territory pages. The Company stated that these were new zip codes added by the U.S. Postal Service after the rate filings were made with the ALDOI. It was noted that the rate filings did not include instructions concerning the assignment of territories for zip codes that were not shown in the zip code/territory pages. In response to the Company's inquiry concerning the requirements for handling new zip codes, the ALDOI recommended that the Company include a statement in its rate filings to the effect that the insured will continue to be rated in the same territory regardless of new zip codes assigned by the U.S. Postal Service, unless a rate change was filed.

Underwriting Practices

Underwriting and Rating Standard 11: Underwriting Practices – The Company underwriting practices are not unfairly discriminatory. The Company adheres to applicable statutes, rules and regulations and Company guidelines in the selection of risks.

It appears that underwriting guidelines were not required to be filed in Alabama.

The Company's underwriting guidelines submitted to the ALDOI and effective during the examination period were used to review the sample of Active Policies. The Company offers three rating tiers for new and renewal business based solely on the commission level selected by the agent - Freedom, Heritage, and Eagle. The Freedom program offers the lowest commission and base rates; the Heritage program offers standard commission and base rates; and the Eagle program offers the highest commission and base rates. Ten policies from the sample were written in the Freedom program, 33 in Heritage, and five in Eagle. The Company appears to be following its underwriting guidelines in the selection of risks.

Underwriting and Rating Standard 12: Underwriting Practices – All forms and endorsements forming a part of the contract are listed on the declarations page and should be filed with the department of insurance.

All Alabama PPA forms and endorsements should be approved by the ALDOI prior to their use in accordance with ALA. CODE § 27-14-8 (1975), and ALA. ADMIN. CODE 482-1-123 (2001).

The Company's PPA policy forms and endorsements employed during the examination period were used to review the sample of Active Policies. The contract lists the endorsements that automatically apply to all Alabama PPA policies and those that apply to Alabama PPA policies only if the form number is shown on the policy declarations. The endorsement form numbers shown on the declarations page were compared to those shown in the policy contract for all policies within the sample.

It appears that all forms and endorsements listed on the declarations page were filed with the ALDOI prior to their use in accordance with ALA. CODE § 27-14-8 (1975), and ALA. ADMIN. CODE 482-1-123 (2001).

Underwriting and Rating Standard 15: Underwriting Practices – File documentation adequately supports decisions made.

The Company maintained hard copies of the completed policy application, policy renewal quotation, check number for down payment or full amount, MVR, endorsement documentation, finance contract if financed, and proof of previous insurance. The underwriting documentation provided by the Company was reviewed for the sample of Active Policies.

File documentation did not appear to adequately support decisions made for four policies within the sample. The “Automobile Renewal Quotation” was not in the underwriting file for one of these four policies, the MVR supporting the violation charge was not on file for one policy, and the MVR supporting the MVR fee charged in the policy was not in file for the two remaining policies.

The Company should maintain complete records of its underwriting transactions and affairs for at least five years in accordance with ALA. CODE § 27-27-29 (1975) and ALDOI Regulation No. 118.

Cancelled/terminated policies

Cancellations – First Sixty Days Cancellations

The Company does not decline any applications. Policies are issued for all submissions and if found unacceptable or the application is incomplete, an underwriting cancellation notice is issued within the first 60 days of coverage.

Termination Practices

Underwriting and Rating Standard 23: Termination Practices – Cancellation/non-renewal and Declination notices comply with policy provisions and state laws and company guidelines.

Underwriting and Rating Standard 24: Termination Practices – Cancellation/non-renewal notices comply with policy provisions and state laws, including the amount of advance notice provided to the insured and other parties to the contract.

ALA. CODE § 27-23-23 (1975) requires that a notice of cancellation for policies that have been in effect for less than 60 days must be mailed or delivered by the insurer at least 20 days prior to the effective date of cancellation for any reason. The notice must state, or be accompanied by a statement, that there is possible eligibility for insurance through the automobile assigned risk plan pursuant to Alabama Law in accordance with ALA. CODE § 27-23-24 (1975). Proof of mailing shall be sufficient proof of notice in accordance with ALA. CODE § 27-23-25 (1975). Unearned premiums are refunded to the premium finance company when premiums are financed in accordance with ALA. CODE §§ 27-40-11(d), and 27-40-12(b) (1975).

ALA. CODE § 27-23 (1975), which references PPA Liability cancellations only, applies to Liability and Physical Damage when both coverages are written on the same policy, and to Liability only if these coverages are written in separate policies. There is no statute concerning cancellation refunds, except when premiums are financed; therefore, the Company's policy provisions, underwriting guidelines and U/W Manual were used. The Company should maintain complete records of its underwriting transactions and affairs for at least five years in accordance with ALA. CODE § 27-27-29 (1975), and ALDOI *Regulation No. 118*.

Cancellation documentation and the underwriting files were reviewed to determine if the cancellation notice was valid; if adequate notice of termination was provided to the insured; if valid reasons for cancellation were used and documented; and if agency cancellations are monitored for appropriate practices. Where applicable; unearned premium documentation was reviewed to verify that unearned premiums were calculated in accordance with state laws policy provisions and rules, and that the appropriate refund has been made to the applicant/insured in a timely manner. Billing documents were reviewed to verify that unearned premiums properly refunded or credited/debited to the insured's account.

Using the "First 60 Days Cancellations" file containing 3,058 cancellations, a statistical sample of 48 items was selected in order to determine compliance with ALA. CODE §§ 27-23-23, 27-23-24, 27-23-25, 27-40-11(d), 27-40-12(b), and 27-27-29 (1975), ALDOI *Regulation No. 118*, and policy provisions, rules and cancellation procedures. The cancellation notice was not provided for two policies; the policy application was not provided for one policy; and a legible early alert/cancellation memo was not provided for three policies.

The Company's cancellation notice did not appear to comply with policy provisions, state laws and Company guidelines as the 46 cancellation notices provided by the Company did not state that the notice of availability of the automobile assigned risk plan is given pursuant to ALA. CODE § 27-23-24 (1975). During the course of the examination, the Company revised its cancellation notice to include the required wording.

Two policy files evidenced incorrect reasons for cancellation. Valid reasons for cancellation and corresponding documentation could not be determined for five policies as no cancellation notice was provided for two, and the "Early Alert Memo" was illegible for three of these policies.

Verification that the appropriate refund was made to the applicant/insured in a timely manner could not be determined for the two policies for which no cancellation notice

was provided.

Cancellations – Non-renewals and Cancellations of Sixty Days or More

Underwriting and Rating Standard 23: Termination Practices – Cancellation/ non-renewal and Declination notices comply with policy provisions and state laws and company guidelines.

Underwriting and Rating Standard 24: Termination Practices – Cancellation/ non-renewal notices comply with policy provisions and state laws, including the amount of advance notice provided to the insured and other parties to the contract.

The combined sample of non-renewals and policies cancelled sixty days from the effective date of coverage or more was reviewed to determine compliance with ALA. CODE §§ 27-23-21, 27-23-23, 27-23-24, 27-23-25, 27-40-11(d), and 27-40-12(b) (1975), and policy provisions, rules and cancellation/non-renewal procedures.

In accordance with ALA. CODE § 27-23-23 (1975), a notice of cancellation for policies that have been in effect 60 days or more must be mailed or delivered by the insurer at least 20 days prior to the effective date of cancellation for one or more of the reasons shown in ALA. CODE § 27-23-21 (1975). If the reason for cancellation is not included, the notice must state, or be accompanied by a statement that, upon written request of the named insured, the reasons will be provided within 15 days, and that there is possible eligibility for insurance through the automobile assigned risk plan pursuant to ALA. CODE 27-23-24 (1975). Proof of mailing, and unearned premiums refunded to the premium finance company were addressed previously in this section under the *First Sixty Days Cancellations* caption.

Cancellation/non-renewal documentation was reviewed to determine if the cancellation notice was valid; if adequate notice of termination was provided to the insured; if valid reasons for cancellation were used and documented; and if agency cancellations are monitored for appropriate practices. Where applicable, unearned premium documentation was reviewed to verify that unearned premiums were calculated in accordance with state laws policy provisions and rules, and that the appropriate refund has been made to the applicant/insured in a timely manner. Billing documents were reviewed to verify that unearned premiums were properly refunded or credited/debited to the insured's account.

Using the "Non-renewals and After Sixty Days" cancellation file containing 2,899 records, a statistical sample of 48 items was selected and reviewed to determine compliance with ALA. CODE §§ 27-23-23, 27-23-24, 27-23-25, 27-40-11(d), and 27-40-12(b) (1975), and policy provisions, rules and cancellation procedures.

The underwriting file was not provided for nine policies, and the nonrenewal notice was not provided for three policies. A proof of mailing date document was not provided for five policies, and a legible proof of mailing date document was not provided for two policies. These documents should be provided in accordance with ALA. CODE §§ 27-23-25 (1975), 27-27-29 (1975), and ALDOI *Regulation No. 118*.

The Company's cancellation notice did not appear to comply with policy provisions, state laws and Company guidelines as the one cancellation notice in the sample did not state that the notice of availability of the automobile assigned risk plan was given pursuant to ALA. CODE § 27-23-24 (1975). During the course of the examination, the Company provided a copy of the cancellation notice revised to include this required wording. Compliance with policy provisions and state laws and Company guidelines could not be determined for 12 policies within the sample as the underwriting file was not provided for nine policies and the non-renewal notice was not provided for the remaining three policies.

The amount of advance notice of cancellation provided to the insured and other parties to the contract could not be determined for 19 policies within the sample as the underwriting file was not provided for nine policies, the non-renewal notice was not provided for three policies, a proof of mailing date document was not provided for five policies, and a legible proof of mailing date document was not provided for the remaining two policies.

Claims Payment Practices

Paid Claims

Paid Claims – Timely Communications

<p><i>Claims Standard 1</i> – <i>The initial contact by the company with the claimant is within the required time frame.</i></p>

A time study was performed a sample of paid claims to determine if the Company has initial contact procedures in place and acknowledgment times are in compliance with the mandated time frame.

The examiners selected a statistical sample, calculated the number of days between the "Report Date" and the "Acknowledgement Date," and analyzed the results. The range of response time was between one and 35 days for the 68 items in the sample, an average of approximately five days. In order to gauge timeliness, the examiners elected to utilize 15 days in accordance with ALA. ADMIN. CODE 482-1-125-.06

(2003) *Failure to Acknowledge Pertinent Communications*. Although not relevant to the examination period, the regulation was enacted on May 27, 2003, effective June 9, 2003. It was noted that there were four items (or 5.88% of the sample) where the response time exceeded 15 days. These findings are not deemed exceptions for the purposes of this examination; however, the Company is reminded that subsequent to the June 9, 2003 effective date, an initial response within 15 days will be required by the aforementioned ALDOI regulation.

Claims Standard 4 – The company responds to claim correspondence in a timely manner.

A time study was performed to determine if subsequent responses and claim handling delay notices comply with applicable statutes, rules and regulations.

Utilizing the previous mentioned sample and the same 15-day timeliness gauge, the examiners calculated the number of days between the “Report Date” and “Delay Notice Date.” One of four delay notice correspondence dates was in excess of 15 days. As previously discussed, ALA. ADMIN. CODE 482-1-125 (2003) now requires the Company to respond to pertinent written communications with a claimant within 15 days.

Paid Claims – Timely Resolutions

Claims Standard 2 – Timely investigations are conducted.

Claims Standard 3 – Claims are resolved in a timely manner.

Utilizing the statistical sample of 68 paid claims, the examiners performed various time studies to determine if claims resolutions, i.e., liability determinations, coverage questions and claim payments, were made in accordance with ALDOI requirements. These included the number of days between:

- Closed Date and Reported Date;
- Sufficient Information Received Date and First Payment Date;
- Settlement Date and First Payment Date, and
- First Payment Date and First Check/Draft Cleared Bank Date.

Ten of 68 items in the sample were still open at the date of the review; consequently, there were no closed dates for those claims. The total of days to close for the other 58 claims was 5,204; accordingly, the average was 89.72 days. Most delays resulted from complete documentation not being received by the Company. Some files were in litigation, and justifiably could not be closed. One file noted claim handling delays

caused by the Company, which resulted in a reduction in the settlement amount to the insured. Delays were also caused by errors in file maintenance and documentation (coding, settlement amounts, payments not made, bills not paid, etc.).

The total number of days between the date sufficient information was received and the first payment date was 1,282, which averaged 18.85 days. Although ALA. ADMIN. CODE 482-1-125 (2003) had not yet been enacted, the examiners elected to utilize 30 days after receipt of proof of loss, and 45 days thereafter for timeliness of notification in accordance with said ALDOI regulation, section .07 *Standard for Prompt, Fair and Equitable Settlements Applicable to All Insurers*.

Nine of 68 files indicated that the first payment date was in excess of 45 days after sufficient information had been received by the Company. Review of these files determined that in the majority of cases, the files had not been properly maintained; as a result, the issuance of claims checks was delayed and therefore, untimely. It was noted that one file documented incorrect dates, whereby the calculation resulted in a negative number. Subsequently, the dates were corrected in the file.

The average time from settlement date to first payment date for the 68 items in the sample was 8.21 days. Two files indicated that the difference was in excess of 45 days. Review of these files, and subsequent discussions with Company personnel determined that an incorrect amount had been paid to the claimant or insured in each case, resulting in an excessive delay between settlement and payment dates.

The examiners calculated an average time of 13.19 days between the first payment date and the date when the check/draft cleared the bank. Considering that banks generally operate on a monthly, or 30-day cycle, the time was not deemed unreasonable. In the sample of 68, one item was in excess of 60 days. The examiners elected to use 60 days as a gauge of timeliness as this would allow for two bank cycles of 30-days each. In addition, it should be noted that there are no requirements that dictate when the claimant or insured should present a check for payment.

Paid Claims – Adequate file documentation

<i>Claims Standard 5 – Claim files are adequately documented.</i>
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ALA. CODE § 27-27-29 (1975), and ALDOI Regulation No. 118, require an insurer to maintain complete and accurate records of its claims transactions for no less than five years. A review of the documents and information provided by the Company for the sample of 68 paid claims determined that file documentation did not appear to be sufficient to support or justify the ultimate claim determination for 11 claims

(approximately 16%). Discrepancies included, but were not limited to the following:

- Copies of the documents referenced in the claim file notes were not provided for six claims. The contact letter was not in two files; the original letter from insured's attorney was not in one file; the supplement appraisal was not in one file; the lawsuit filed against the Company was not in one file; and the police report was not in one file.
- An incorrect paid amount was in the Company's data file for one claim, which was determined to be a computer system error.
- Voided checks were not shown on the Company's "List of Outstanding Checks" for four claims as a replacement check and documentation supporting each voided check transaction were not provided in accordance with ALA. CODE § 27-36-1 (1975), *SSAP No. 5*, of the AP&P Manual, the A/S Instructions, and SUFI's "Transactions Types" guidelines. A more detailed discussion on this matter may be found in "Note 8 – Losses" in the NOTES TO FINANCIAL STATEMENTS section of the examination report.
- Voided checks should have been included in *Report of Unclaimed Property* filed by SUFI for the above mentioned four claims in accordance with ALA. CODE § 35-12-31 (1975), and ALDOI *Regulation No. 66*. In addition, unclaimed property was discussed in "Note 13 - Amounts withheld by company for account of others," in the NOTES TO FINANCIAL STATEMENTS section of this report.

Paid Claims – Based on policy provisions, ALDOI statutes, etc.

Claims Standard 6 – Claims are properly handled in accordance with policy provisions and applicable statutes, rules and regulations.

Claim Standard 12 – Canceled benefit checks and drafts reflect appropriate claim handling procedures.

The examiners reviewed the sample of 68 paid claims files to determine if claims were properly handled in accordance with policy provisions, applicable ALDOI statutes, rules and regulations, and NAIC Claims Standards. The following discrepancies were noted:

- Notification concerning the reason for a reduced settlement/paid amount was not provided to the insured/claimant for two claims.
- Notification to insured/claimant that paid amount was "full and final" was not provided for 16 claims. ALA. ADMIN. CODE 482-1-125-.05(3) (2003), now requires that the policy limit be paid or a compromise settlement amount

agreed to by the first party and the insurer, before an insurer can indicate that said payment is “final” or “a release.”

- The written estimate did not include the disclosure statement regarding non-original equipment manufacturer aftermarket crash parts in accordance with ALA. CODE § 32-17A-3 (1975) for three claims. It was noted that the previous examination recommended the Company “take measures to ensure that all estimates utilizing aftermarket crash parts include the disclosure...”
- Company claim handling delays caused reduced settlement amount payable to the insured for one claim.
- Coding was not correct for four claims. Two files should have been coded as a loss adjustment (LA) in lieu of a loss paid (LP), and one file should have been coded LP instead of LA in accordance with *SSAP No. 55*, of the AP&P Manual and SUFI’s “Transactions Types” guidelines. One file should have been coded under comprehensive (CP) coverage, not Collision (CL) coverage in accordance with *Part III. COVERAGES, Section D, Coverage E: Comprehensive Coverage* of the “Alabama Private Passenger Auto Policy Form & Endorsements” and SUFI’s “Transactions Types” guidelines. Complete records were not maintained in accordance with ALA. CODE § 27-27-29 (1975), and ALDOI *Regulation No. 118* for all four files.
- Medical payments subrogation amount was not paid to the claimant’s carrier for one claim.
- Medical bills shown in the paper claim file were not paid for one claim.
- Supplement appraisal was paid twice for one claim.
- Incorrect settlement amount was paid to the insured or claimant for one claim.
- As noted previously under “Claims Standard 5,” voided checks for four claims should have been included on the annual unclaimed property filings.

Denied Claims

Denied Claims – Acknowledgement of Pertinent Communications

Claims Standard 1 – The initial contact by the company with the claimant is within the required time frame.

A time study was performed on a sample of denied and closed-without-payment claims to determine if the Company had initial contact procedures in place and acknowledgment times were in compliance with the mandated time frame.

The examiners selected a statistical sample, calculated the number of days between the “Report Date” and the “Acknowledgement Date,” and analyzed the results. The

range of response time was between one and 431 days for the 68 items in the sample, an average of approximately 15 days. In order to gauge timeliness, the examiners elected to utilize 15 days in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003) *Failure to Acknowledge Pertinent Communications*. Although not relevant to the examination period, the regulation was enacted on May 27, 2003, and effective on June 9, 2003. It was noted that there were four items (or 5.88% of the sample) where the response time exceeded 15 days. Again, these findings are not deemed exceptions for the purposes of this examination; however, the Company is reminded that subsequent to June 9, 2003, an initial response within 15 days will be required by the referenced ALDOI regulation.

Claims Standard 4 – The company responds to claim correspondence in a timely manner.

A time study was performed to determine if subsequent responses and claim handling delay notices comply with applicable statutes, rules and regulations.

Utilizing the sample discussed above and the same 15-day timeliness gauge, the examiners calculated the number of days between the “Report Date” and “Delay Notice Date.” One of four delay notice correspondence dates was in excess of 15 days. As previously mentioned, ALA. ADMIN. CODE 482-1-125-.06 (2003) now requires the Company to respond to pertinent written communications with a claimant within 15 days.

In addition, the examiners calculated the number of days between the “Delay Notice Date” and the “Denial/Closed-Without-Payment Date,” using 45 days as timely. All four communications after the initial notification were in excess of 45 days. ALA. ADMIN. CODE 482-1-125-.07 (2003) now requires insurers to provide written responses every 45 days, as additional time is needed for investigation.

Claims denied or closed-without-payment – Adequate file documentation

Claims Standard 5 – Claim files are adequately documented.

ALA. CODE § 27-27-29 (1975), and ALDOI Regulation No. 118, require an insurer to maintain complete and accurate records of its claims transactions for no less than five years. A review of the documents and information provided by the Company for the sample of 68 denied or closed-without-payment claims determined that file documentation does not appear to be sufficient to support or justify the ultimate claim determination for five claims (approximately seven percent). Discrepancies included, but were not limited to the following:

- The paper claim file was not provided for two closed-without-payment/denied claims within the sample.
- A “Reservation of Rights” letter was not in the paper claim file for one claim.
- A “Close File w/No Pay Letter” (G9) was not in the paper claim file for one claim.
- Medical information referenced in the claim file notes was not in the paper claim file for one claim.

All documentation and files for denied and closed-without-pay claims should be maintained in accordance with aforementioned section of the *Alabama Insurance Code*, and ALDOI regulation.

Claims denied and closed-without payment – Policy provisions and state law

Claims Standard 11 – Denied and closed-without-payment claims are handled in accordance with policy provisions and state law.

The sample of 68 denied and closed-without-payment claims was reviewed in order to determine if the claims were handled in accordance with policy provisions, applicable ALDOI statutes, rules and regulations, and NAIC Claims Standards. The following items were noted:

- The paper claim file could not be located for two closed-without-payment/denied claims within the sample; consequently, a reasonable basis for denial could not be determined. These documents should be provided in accordance with ALA. CODE § 27-27-29 (1975), and ALDOI *Regulation No. 118*.
- One claim was handled incorrectly due to underwriting analysis. The insured made the renewal down payment to the agent on the policy expiration date. The loss occurred on the new business expiration/renewal offer effective date. The Company renewed the policy with a two day lapse in coverage. Payment to the agent is deemed payment to the Company; therefore, the policy should have been renewed with no lapse in coverage, and the claim for the loss occurring on the new business expiration/ renewal offer effective date of the policy should have been paid. The file did not evidence that the claimant was provided with a reasonable basis for denial.
- The Company appeared to have a reasonable basis for denial for 65 closed-without-payment/denied claims in the sample.

Privacy Policies and Practices

[Compliance with ALA. ADMIN. CODE 482-1-122 (2002), formerly known as ALDOI *Regulation No. 122*.]

The Company appears to have policies and procedures in place to protect the privacy of nonpublic personal financial information relating to its customers. On June 30, 2001, the initial privacy notice was mailed on the Company's behalf to all existing policyholders by the upline parent company, Kingsway America, Inc.

The Company provides a privacy notice to its customers regarding the treatment of nonpublic personal financial information. This notice, which serves as both the initial and annual notice, is delivered to the Company's customers with both the new business and the renewal business declaration pages. It appears to be clear and conspicuous and accurately reflect privacy policies and practices in accordance with Sections .05A(1), .06A(1), .07 and .10, of ALA. ADMIN. CODE 482-1-122 (2002). The requirement for a revised notice in this regulation is not applicable since the Company has not changed its notice. The requirement for a simplified notice in Section .07C(5) of the regulation is not applicable as the Company issues an initial and annual notice. The requirement for a short-form notice for non-customers in Sections .07D and .10 of the previously referenced regulation is not applicable since the Company does not have consumers who are not customers.

Opt out policies and procedures, and opt out notices do not appear to be applicable since the Company does not collect non-public personal financial information for consumers nor disclose nonpublic personal financial information about its customers to nonaffiliated third parties, except as permitted by law. Section 15A of ALA. ADMIN. CODE 482-1-122 (2002) states the following:

“The requirements for initial notice in Section 5A(2), the opt out in Sections 8 and 11, and service providers and joint marketing in Section 14 do not apply if the licensee discloses nonpublic personal financial information as necessary to effect, administer or enforce a transaction that a consumer requests or authorizes...”

The opt out disclosure and the capability to keep nonpublic personal financial information from being disclosed to nonaffiliated third parties when a consumer or customer has opted out in Section .11, and the opt out notice in Section .08 of the aforementioned regulation do not seem to be applicable as the Company does not collect non-public personal financial information for consumers or disclose nonpublic personal financial information about its customers to nonaffiliated third parties, except as permitted by law.

The Company's collection, use and disclosure of nonpublic personal financial information appears to be in compliance with applicable statutes, rules and regulations. The disclosure requirements to nonaffiliated third parties for joint marketing purposes in Section .14 of ALA. ADMIN. CODE 482-1-122 (2002) are not applicable as the privacy notice states that the Company does not disclose non-public personal financial information to non-affiliated third parties, except as permitted by law. The inclusion of nondisclosure requirements in sample service agreements under which nonaffiliated third parties market the Company's products and services in the regulation are not applicable as the privacy notice states that the Company does not disclose non-public personal financial information to non-affiliated third parties, except as permitted by law. The Company seems to have policies in place to disclose nonpublic personal financial information that it receives from a nonaffiliated financial institution in accordance with Section .12 of the previously referenced regulation as the privacy notice states that it restricts access to non-public personal financial information to those of employees and other parties necessary to provide products and services to its customers. The Company appears to prohibit the disclosure of policy numbers or similar forms of access numbers or access codes to any nonaffiliated third party, except as permitted by applicable law or regulation regarding privacy in accordance with Section .13 of the regulation as the Company does not disclose information regarding a customer's policy to non-affiliated third parties, except in connection with the servicing or processing of an insurance product or service authorized by the customer.

REINSURANCE

Reinsurance Assumed

During the period covered by the examination, the following agreements were entered into between the Company and State and County Mutual Fire Insurance Company (SCMFIC), an insurance company organized under the laws of the State of Texas:

- Effective April 15, 1998, a 100% Quota Share Reinsurance Agreement with SCMFIC, and with the affiliated Southern United General Agency of Texas, Inc. (SUGAT), as intermediary.
- Effective July 1, 1999, General Reinsurance Corporation (GRC), a Delaware corporation, assumed the premiums from SCMFIC under a 100% *Quota Share Reinsurance Agreement No. 8774*. The Company assumed the premiums under *Retrocession Agreement No. 2229*, effective as of the aforementioned date.

- Effective July 1, 2000, Kingsway Reinsurance Corporation (KRe), an affiliate, assumed SCMFIC business from GRC, thereby removing the Company as retrocessionaire.
- An application, dated July 23, 2002, was made to the ALDOI by the Company, indicating an intent to re-enter into a quota share reinsurance agreement with SCMFIC, effective March 1, 2002. The contract was reviewed by the ALDOI and the application was rejected. At the date of this report, no further activity on this matter had been noted.

Since July 1, 2000, no premiums were assumed by the Company from SCMFIC. Loss reserves on known cases reported on *Schedule F – Part 1*, amounted to \$1,046,910, as of December 31, 2001. All business was in run-off as of the examination date.

Reinsurance Ceded

During the examination period, the Company's ceded reinsurance program consisted of the following three reinsurance contracts with KRe, a related party:

- Automobile Quota Share Reinsurance Agreement.
- Automobile Increased Limits Program Reinsurance Agreement.
- Bond Quota Share Reinsurance Agreement.

Automobile Quota Share Reinsurance Agreement

The contract with KRe was effective July 1, 1999, and was subsequently amended on September 1, 2000. The *Automobile Quota Share Reinsurance Agreement* reinsured 75% of the Company's net liability on all policies of business classified as private passenger automobile, motorcycle and commercial automobile, including assumed business. The Company's net liability is the Ultimate Net Loss up to the minimum statutory liability limits as determined by the individual state of jurisdiction in which the loss occurred, or any higher policy limits. The maximum risk insured by the Company for insured vehicle value was as follows:

Automobile Physical Damage:

Maximum Private Passengers	\$ 50,000
Maximum Commercial Automobile	120,000

Inland Marine Physical Damage:

Maximum Inland Marine per risk	\$150,000
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Automobile Increased Limits Program Reinsurance Agreement

The contract was effective November 1, 1998, and was subsequently amended

effective September 1, 1998. The *Automobile Increased Limits Program Reinsurance Agreement* reinsures all of the interest of the Company in excess of the minimum statutory limits issued under all policies of private passenger automobile liability, motorcycle liability, and commercial automobile liability, including assumed business.

Bond Quota Share Reinsurance Agreement

The *Bond Quota Share Reinsurance Agreement* with Kre, which was effective July 1, 1999, and in use during the examination period, was terminated effective July 1, 2001. The Company ceded an 80% share of the net liability of bond limits issued. The portion not reinsured was retained by the Company. The agreement included the following limits:

- The maximum bond term shall be 36 months, with the exception of notary bonds whose maximum bond term shall be 48 months.
- The maximum Surety and Performance bond limit, including Bid bonds, issued by the Company, shall be \$1,000,000, or so deemed.
- Maximum Fidelity bond limit \$250,000, or so deemed.
- Maximum per principal limit \$1,500,000.

As of the examination date, no bond surety policies were written by the Company.

The automobile quota share and bond quota share reinsurance agreements were submitted with Form D for approval on May 27, 1999. The ALDOI was prepared to grant approval of the agreements upon the submission of a copy of the letter of credit (LOC). Although an LOC with the initial issue date of December 31, 1999, was presented to the examiners, there was no correspondence of disapproval of the contracts from the ALDOI.

During the examination period, the Company also utilized various reinsurers with EWI RE Inc., New York, New York, as a reinsurer intermediary. All contracts with EWI RE Inc., are in their run-off stages. The Company reported reinsurance recoverables on loss and loss adjustment expense (LAE) payments, including reserve credits in its *Quarterly Statement as of June 30, 2002*.

Catastrophe Reinsurance

Aggregate Property Catastrophe Excess of Loss Reinsurance Agreement

The Company was a named insured under a consolidated group policy, entitled *Aggregate Property Catastrophe Excess of Loss Reinsurance Agreement*. The policy, effective July 1, 2001, was maintained with various reinsurers and serviced by Aon Re Inc., an intermediary. The agreement indemnified the Company with respect to the in-force

business classified as property and which accrued as a result of loss or losses occurring during the term of the aforementioned agreement.

The reinsurer will indemnify \$1,000,000 of Ultimate Net Loss in the aggregate in excess of \$1,000,000.

Excess Property Catastrophe Reinsurance Agreement

The Company was a named insured in an *Excess Property Catastrophe Reinsurance Agreement*, effective July 1, 2001, which reinsured the Company for excess liability which may accrue under its policies, contracts and binders of insurance or reinsurance in force at the effective date. The Company shall retain and be liable for the amount of Ultimate Net Loss in respect each excess layer.

	FIRST EXCESS	SECOND EXCESS	THIRD EXCESS
Company's Retention	\$1,000,000	\$2,000,000	\$ 5,000,000
Reinsurer's Per Occurrence Limit	1,000,000	3,000,000	10,000,000
Reinsurer's Annual Limit	1,000,000	6,000,000	20,000,000

The aforementioned coverages were provided by several participating reinsurers, with John B. Collins Associates Inc., as intermediary.

RISK-BASED CAPITAL (RBC)

The RBC requirements developed by the NAIC measure the adequacy of a insurer's capital and surplus based on each insurer's unique risk profile. The RBC formula for a property and casualty company (P&C) includes the following four major types of risk:

- investment risk
- credit risk
- underwriting risk
- off-balance sheet risk.

In addition to the RBC formulas and reporting requirements, the Insurers Model Act (Model Act) has established duties for the insurer and the insurance regulators based on the level of the insurer's *total adjusted capital* (TAC) compared to *authorized control level* RBC (ACLR). The ratio of the TAC to the ACLR will trigger one of the following

levels as defined in the Model Act:

	<u>RATIO</u>	<u>RBC LEVEL</u>
i.	200% and above	Adequate Level
ii.	150%-199%	Company Action Level
iii.	100%-149%	Regulatory Action Level
iv.	70%-99%	Authorized Control Level
v.	Below 70%	Mandatory Control Level

Chapter 2B of the *Alabama Insurance Code* requires that every domestic insurer prepare and submit by each March 1, to the Commissioner a report of its RBC levels for the calendar year just ended. The Company filed an RBC report for the year ended December 31, 2001, in accordance with ALA. CODE § 27-2B-3 (1975). The ratio of TAC to ACLR was calculated to be 181%, or Company Action Level.

This examination determined that the Company did not reimburse \$845,099 in commission paid to producers by CIMC for the month of January 2001. The error contributed to TAC being overstated by the aforementioned amount. Had there been no error, the TAC would be \$6,606,304, instead of \$7,451,403, and the calculated RBC at Regulatory Action Level (147%) instead of the reported Company Action Level (181%). (For further discussion, see “Note 15 – Payable to parent, subsidiaries and affiliates” caption in the NOTES TO FINANCIAL STATEMENTS section of this report.)

The examination on the June 30, 2002, Quarterly Statement (Q/S), required examination changes to the Company’s financial statements; changes were made to correct insufficient loss and LAE reserves, leading to a change in the reported contingent commissions liability, and changes to meet statutory and regulatory investment limitations. Examination adjustments in the amount of \$12,716,230 reduced *Unassigned funds (surplus)* to \$(26,798,287). The decrease to *Unassigned funds (surplus)* reduced *Surplus as regards policyholders* from the reported amount of \$11,105,393 to \$(1,610,837). See the “Note 17 – Unassigned funds (surplus)” caption in NOTES TO FINANCIAL STATEMENTS.)

The TAC, which is used to calculate the RBC level, is the sum of the statutory capital and surplus (listed as *Surplus as regards policyholders*) in the Q/S and any other amount provided by RBC Instructions; as such, the TAC as of June 30, 2002 was negative \$1,610,837. During the examination, several corrective actions were taken by the Company. The disparity in the loss and LAE reserves noted at the examination date decreased considerably, capital contributions were made by the Company’s parent, and improvements in the Company’s financial statements were noted. However, the

losses and LAE were determined to be inadequate at December 31, 2002, leading to an elevated RBC level. (See the discussions on “RBC” and “Losses and loss adjustment expenses” in the SUBSEQUENT EVENTS section, later in this report.)

ACCOUNTS AND RECORDS

The Company’s accounting records were maintained primarily on electronic data processing (EDP) equipment. Management and record-keeping functions were performed by personnel and facilities of CIMC under the previously mentioned *Management Facilities and Services Agreement*. A detailed discussion on the aforesaid agreement is included in the HOLDING COMPANY AND AFFILIATE MATTERS section under the caption “Transactions and Agreements with Affiliates,” elsewhere in this report.

The Company was audited annually by the independent certified public accounting (CPA) firm of KPMG Peat Marwick, Birmingham, Alabama, which conducted all of the Company’s audits for the period covered by this examination. The reports and management letters generated by the CPAs were reviewed for the examination period. CPA workpapers were utilized during the examination where deemed appropriate.

The reserve calculations for the examination period were certified by the Company’s actuarial consultant, Mr. Aaron M. Halpert, ACAS, MAAA, with KPMG Peat Marwick, Atlanta, Georgia.

Accounting Practices

The ALDOI recognizes only statutory accounting practices prescribed or permitted by the State of Alabama for determining and reporting the financial condition and results of operations of an insurance company, thereby determining its solvency under the *Alabama Insurance Code*. The AP&P Manual was adopted as a component of prescribed or permitted practices by the State of Alabama.

Accounting Changes

Effective January 1, 2001, the State of Alabama required that Alabama-domiciled companies prepare their statutory basis financial statements in accordance with the AP&P Manual, subject to any deviations prescribed or permitted by the Insurance Commissioner of the State of Alabama.

Item 2.A., of the *Notes to Financial Statements* at the examination date, the Company

reported the following:

“Accounting changes adopted to conform to the provisions of the NAIC Accounting Practices and Procedures manual – Version effective January 1, 2001 are reported as changes in accounting principles. The cumulative effect of changes in accounting principles is reported as an adjustment to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principles had been applied retroactively for all prior periods. As a result of these changes, the company reported a change of accounting principle, as an increase in unassigned funds (surplus), of \$728,251 as of January 1, 2001. The entire adjustment is related to deferred tax assets.”

It was noted that the Company did not provide all requested information to the examiners in a timely manner in accordance with ALDOI *Regulation No. 118*. The records in question were related to, but were not limited to, the following items:

- Numerous electronic data files, including descriptions of codes and other fields;
- Various data sets, including cash disbursements/receipts, unearned premiums, inforce listings, paid claim history;
- Supporting documentation concerning bond acquisitions, common stocks, cash and short-term investments, premiums and agents' balances, losses and loss adjustment expenses, accrual for expenses; and
- Responses from attorney firms retained by the Company in reference to pending litigation.

Detailed discussions and additional commentary on these matters may be found in the NOTES TO FINANCIAL STATEMENTS and COMMENTS AND RECOMMENDATIONS sections of this examination report, under the captions to which they pertain.

FINANCIAL STATEMENTS INDEX

The Financial Statements included in this report were prepared on the basis of the Company's records, and the valuations and determinations made during the examination for the year-to-date, June 30, 2002. Amounts shown in the comparative statements for the quarter ended June 30, 2002, and for the years 1998, 1999, 2000, and 2001, were compiled from Company copies of filed Quarterly and Annual Statements. The statements are presented in the following order:

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Statement of Assets	48
Statement of Liabilities, Surplus and Other Funds	49
Statement of Income	50
Capital and Surplus Account	51

**FAILURE OF FINANCIAL STATEMENTS TO BALANCE TO
INDICATED TOTALS IS DUE TO ROUNDING.**

**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL
STATEMENTS IN THIS REPORT ARE AN INTEGRAL PART
THEREOF.**

SOUTHERN UNITED FIRE INSURANCE COMPANY

STATEMENT OF ASSETS

For Year-to-Date (Quarter Ended June 30, 2002)

	<u>Assets</u>	<u>Non- admitted Assets</u>	<u>Net Admitted Assets</u>	<u>Prior Year Net Admitted Assets</u>
Bonds (Note 1)	\$ 7,270,555	\$	\$ 7,270,555	\$ 7,153,280
Common stocks	1,000	1,000		
Real estate:				
Properties occupied by the company	2,680,121		2,680,121	2,715,371
Properties held for production of income (Note 2)	462,197	165,947	296,250	296,250
Properties held for sale				
Cash and short-term investments (Note 3)	<u>10,902,822</u>	<u>5,624,911</u>	<u>5,277,911</u>	<u>7,273,926</u>
Subtotals, cash and invested assets	\$21,316,695	\$ 5,791,858	\$15,524,837	\$17,438,827
Agents' balances or uncollected premiums:				
Premiums and agent's balances in course of collection (Note 4)	92,305	92,305		296,794
Premiums, agents' balances and installments booked but deferred and not yet due	6,978,875	81,764	6,897,111	7,784,902
Reinsurance recoverables on loss and loss adjustment expense payments (Note 5)	500,526		500,526	459,227
Federal and foreign income tax recoverable and interest thereon (including \$728,251 net deferred tax asset) (Note 6)	5,618,318	2,052,926	3,565,392	2,456,457
Guaranty funds receivable or on deposit (Note 7)	67,784	67,784		637,669
Electronic data processing equipment and Software	2,918		2,918	47,318
Interest, dividends and real estate income due and accrued	106,304		106,304	103,925
Receivable from parent, subsidiaries and Affiliates				
Aggregate write-ins for other than invested Assets:				
Prepaid Expenses	<u>321,477</u>	<u>321,477</u>	<u>0</u>	<u>0</u>
TOTALS	<u>\$35,005,202</u>	<u>\$ 8,408,114</u>	<u>\$26,597,088</u>	<u>\$29,225,119</u>

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTERGRAL PART THEREOF.

SOUTHERN UNITED FIRE INSURANCE COMPANY
STATEMENT OF LIABILITIES, SURPLUS AND OTHER FUNDS
For Year-to-Date (Quarter Ended June 30, 2002)

	<u>Current</u> <u>Statement Date</u>	<u>December 31,</u> <u>Prior Year</u>
LIABILITIES		
Losses (Note 8)	\$ 6,804,772	\$ 4,593,654
Loss adjustment expenses (Note 9)	1,834,228	925,162
Commissions payable, contingent commissions and other similar charges (Note 10)	9,658,953	7,521,466
Other expenses	59,658	66,354
Taxes, licenses and fees	1,948,119	2,417,765
Unearned premiums (after deducting unearned premiums for ceded reinsurance of \$14,754,144) (Note 11)	4,908,665	4,849,211
Advance premium (Note 12)	169,345	
Ceded reinsurance premiums payable	1,039,895	17,277
Amounts withheld or retained by company for account of others (Note 13)		
Provision for reinsurance (Note 14)	50,600	50,600
Payable to parent, subsidiaries and affiliates (Note 15)	<u>1,733,690</u>	<u>1,332,227</u>
Total liabilities	<u>\$ 28,207,925</u>	<u>\$ 21,773,716</u>
SURPLUS AND OTHER FUNDS		
Common capital stock	\$ 1,500,000	\$ 1,500,000
Surplus notes (Note 16)	2,921,250	2,921,250
Gross paid in and contributed surplus (Note 17)	20,766,200	14,766,200
Unassigned funds (surplus) (Note 18)	<u>(26,798,287)</u>	<u>(11,736,047)</u>
Surplus as regards policyholders	<u>(1,610,837)</u>	<u>7,451,403</u>
TOTALS	<u>\$ 26,597,088</u>	<u>\$ 29,225,119</u>

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTERGRAL PART THEREOF.

SOUTHERN UNITED FIRE INSURANCE COMPANY
CAPITAL AND SURPLUS ACCOUNT
For Year-to-Date (Quarter Ended June 20, 2002), and
Prior Years Ended December 31, 1998, 1999, 2000, and 2001

	<u>06/30/2002</u>	<u>12/31/2001</u>	<u>12/31/2000</u>	<u>12/31/1999</u>	<u>12/31/1998</u>
CAPITAL AND SURPLUS ACCOUNT					
Surplus as regards policyholders, December 31, prior year	\$ <u>7,451,403</u>	\$ <u>6,269,179</u>	\$ <u>7,543,996</u>	\$ <u>8,364,877</u>	\$ <u>5,906,915</u>
GAINS AND (LOSSES) IN SURPLUS					
Net income	\$ (9,004,289)	\$ (4,093,459)	\$(2,789,802)	\$ (342,586)	\$(1,939,775)
Change in net deferred income tax		1,951,593			
Change in nonadmitted assets	(5,888,606)	(2,352,561)	814,985	(219,295)	485,637
Change in provision for reinsurance		(50,600)			5,000
Cumulative effect of changes in accounting principles		728,251			
Surplus adjustments:					
Paid in	6,000,000	5,000,000	700,000		3,995,000
Aggregate write-ins for gains and losses in surplus:					
Non-admitted investment in sub examination adjustments for liabilities (Note 11)	(169,345)	(1,000)			
Amortization of capitalization assessment credits expenses in prior Years	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(87,900)</u>
Change in surplus as regards Policyholders for the year	\$ <u>(9,062,240)</u>	\$ <u>1,182,224</u>	\$(1,274,817)	<u>(561,881)</u>	<u>2,457,962</u>
Surplus as regards policyholders, December 31 current year	\$ <u>(1,610,837)</u>	\$ <u>7,451,403</u>	\$ <u>6,269,179</u>	\$ <u>7,802,996</u>	\$ <u>8,364,877</u>

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTEGRAL PART THEREOF.

NOTES TO FINANCIAL STATEMENTS

Note 1 – Bonds

\$7,270,550

The captioned amount is the same as reported by the Company in the *Quarterly Statement as of June 30, 2002*.

A review of *Schedule D – Part 5*, determined that there was one bond (Tammany Parish WID, Cusip-793572-JB-5), that was called on March 1, 2001. The Company had not amortized the bond to its par value at the call date thereby overstating the value by \$6,820. Hence, the Company had not complied with the *SSAP No. 26*, Section 6, of the AP&P Manual which states in pertinent part:

“Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer’s discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).”

Furthermore, a review of the amortization method used during the period covered by the examination determined that the Company used the straight-line method. According to *SSAP No. 26*, Section 6, of the AP&P Manual,

“Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principle provisions over the life of the bond.”

Therefore, the Company was not in compliance with *SSAP No. 26*, Section 6, of the AP&P Manual.

Note 2 – Real estate:

Properties held for the production of income

\$296,250

The captioned amount is the same as the \$296,250 reported in the Company’s *Quarterly Statement as of June 30, 2002*.

The examiner reviewed the last appraisal of the Commercial Rental Property and noted that it was completed on January 20, 1992. The date of the last appraisal was more than the three years allowed by ALA. CODE § 27-37-7(b) (1975), which states that:

“Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than three years old, the commissioner may at his discretion call for and require a new appraisal in order to determine fair value.”

Also, *SSAP No. 40*, paragraph 12 of the AP&P Manual states,

“All appraisals obtained to determine fair value of real estate investments shall be no more than five years old. However, if conditions indicate there has been a significant decrease in the fair value of a property, a current appraisal shall be obtained. Additionally, appraisals shall be obtained for real estate investments at the time of foreclosure or contribution. Contributed real estate shall be supported by an independent third party appraisal at the date of contribution. If any of the previous conditions exist but an appraisal has not been obtained, the related property shall be considered a non-admitted asset until the required appraisals are obtained.”

Utilizing the above guidelines, and in the event the Company wishes to admit the real estate, then an updated appraisal should be obtained in accordance with the aforementioned *Alabama Insurance Code*.

On May 27, 2003, subsequent to the examination period, the Company acquired a new appraisal on the Commercial Rental Property. Consequently, the property has been admitted for the purposes of this examination.

Furthermore, the Company could not produce original cost records for the *Properties occupied by the company*, in violation of ALA. CODE § 27-27-29(a) (1975), which states,

“Every domestic insurer shall have, and maintain its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind or kinds, of insurance transacted.”

The Company, by not keeping complete original cost records, is also in violation of ALA. CODE § 27-27-30(a) (1975), which requires that:

“No insurer shall make any disbursement of \$25.00 or more unless evidenced by a voucher or other document correctly describing the

consideration for the payment and support by a check or receipt endorsed or signed by, or on behalf of, the person receiving the money.”

Note 3 - Cash and short-term investments

\$5,277,911

The captioned asset is \$5,624,911 less than the \$10,902,822 amount reported in the Company's *Quarterly Statement as of June 30, 2002*.

The examination has determined that the Company's short-term investment made under the repurchase agreement with Whitney Bank was subject to the investment limitation of ALA. CODE § 27-41-6(a) (1975), which stipulates that:

“... an insurer shall not have at any one time any single investment or combination of investments in or loans upon the security of the obligation, property or security of any one person aggregating in cost to the insurer in excess of the greater of 10 percent of such insurer's assets or the total of its capital and surplus, as shown in the latest annual report of the insurer filed pursuant to subsection (a) of section 27-3-26 of the Alabama Insurance Code, less the minimum capital and surplus required of said insurer...”

At the examination date, the Company had the following account balances with Whitney Bank:

ACCOUNT DESCRIPTION	AMOUNT
Deposit Account – MMA	\$ 742,522
Operating Account	152,698
Certificate of Deposits (3)	155,000
Short-term investment - Repurchase Agreement	<u>11,626,094</u>
TOTAL	<u>\$ 12,676,314</u>

Utilizing the guidelines as defined in the aforementioned section of the *Alabama Insurance Code*, the examiners determined that the capital and surplus, less the minimum \$500,000 surplus required, or \$6,951,403 was the greater amount. FDIC coverage of \$100,000 increased the limitation to \$7,051,403. The total of cash and short-term investments in Whitney Bank on June 30, 2002, was \$12,676,314. Therefore, \$5,624,911 [(12,676,314 - 7,051,403)] was not admitted in accordance with ALA. CODE § 27-41-6(a) (1975).

It should be noted that with the filing of the *Quarterly Statement as of March 31, 2003*, the Company had alleviated the excess thereby reducing the account balances to within acceptable limits. A more detailed discussion on this matter may be found under the "Cash and short-term investments" caption in SUBSEQUENT EVENTS.

At the examination date, the fair value of the collateral pledged by Whitney Bank was \$11,853,200, which is \$5,415 less than required by *SSAP No. 45* of the AP&P Manual which states,

"The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

- a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price."

Furthermore, the examination determined that the Company did not report its repurchase agreement transactions under item 19.2 of the Investment section of the *General Interrogatories* as instructed by the A/S Instructions.

It was also noted that the Company used a CUSIP number to identify the repurchase agreement in column 1 of *Schedule DA - Part 1* of the 2001 Annual Statement. The CUSIP reported was that of the underlying security and not the account number of the repurchase agreement. Section 27-37-1 of the *Alabama Insurance Code* stipulates that only those assets "as are owned by the insurer" shall be allowed as admitted assets.

Note 4 – Agents' balances or uncollected premiums:

Premiums and agents' balances in course of collection

\$ -0-

The captioned amount is \$92,305 less than the \$92,305 reported by the Company in its *Quarterly Statement as of June 30, 2002*.

According to the Company's accounts and records, the aforementioned amount consisted of the following accounts:

ACCOUNT DESCRIPTION	AMOUNT
Account receivable from producers	\$58,718
Producers checks returned unpaid (NSFS, per Company)	32,027
Receivable from finance company	1,560
TOTAL	<u>\$92,305</u>

The examination determined the following:

- The account receivable from producers in the amount of \$58,718 was due to the commission refunds owed by agents on commission paid to producers on written premiums, rather than on premiums owed by the agents per the guidance provided by A/S Instructions, and *SSAP No. 6*, paragraph 6, of the AP&P Manual. The said amount met the definition of a nonadmitted asset in accordance with *SSAP No. 4*, of the AP&P Manual.
- The producers checks returned unpaid consisted of returned checks received from agents. During the examination, Company management recognized that the actual amount was \$10,098, which was \$21,929 less than the \$32,027 amount reported. Subsequently, the error was corrected by the Company. Said amount met the definition of a nonadmitted asset in accordance with *SSAP No. 4*, of the AP&P Manual.
- The \$1,560 receivable from the finance company was considered a wash transaction, according to *SSAP No. 6*, paragraph 13, of the AP&P Manual. The referenced amount met the definition of a nonadmitted asset in accordance with *SSAP No. 4*, of the AP&P Manual.

Due to the exceptions mentioned above, *Premiums and agents' balances in course of collection* has been reduced by \$92,305, for the purposes of the examination. Subsequent to the examination period, the Company not admitted this asset on its *Quarterly Statement as of June 30, 2003*.

It was noted that the Company could not provide all requested information in accordance with *ALDOI Regulation No. 118*, which requires the Company to provide a response to requested information within 10 working days. The previous examination noted the same.

**Note 5 – Reinsurance recoverables on loss and
loss adjustment expense payments**

\$ 500,526

The captioned amount is the same as reported in the Company's *Quarterly Statement as of June 30, 2002*, but \$72,879 more than the \$427,647 determined by this examination. Due to immateriality, no changes were made to the financial statements for the purposes of the examination.

The aforementioned amount consisted of the following receivables as listed in the Company's workpapers:

	ACCOUNT DESCRIPTION	AMOUNT
I.	Contingent commissions	\$50,997
II.	Catastrophe premium adjustments	21,882
	TOTAL	<u>\$72,879</u>

I. Contingent commission

The examiners utilized the normal auditing procedures to verify the accuracy, completeness and regulatory compliance of *Schedule F* of the *Annual Statement as of December 31, 2001* (2001 A/S). Reinsurance transactions for the first six months of 2002 were added to establish the reinsurance recoverable in the mid-year evaluation date of this examination. The examiners concluded that the \$50,997 in contingent commission, which was recorded as reinsurance recoverable in the 2001 A/S, existed as of June 30, 2002. The said amount was inappropriately reported in the aforementioned asset.

A/S Instructions and *SSAP No. 62*, paragraph 19, of the AP&P Manual, require that *Reinsurance recoverables on loss and loss adjustment expense payments* include only ceded reinsurance recoverables on loss payments made by the Company. Recording the recoverable for contingent commissions violated the guidance provided by the A/S Instructions and AP&P Manual. *ALDOI Regulation No. 97*, also states that:

“...all insurers shall use the appropriate NAIC Annual Statement Blank which shall be prepared in accordance with the NAIC Annual Statement Instructions...”

Contingent commissions recoverable from a reinsurer is recorded as an offset to the *Commissions payable, contingent commissions and other similar charges* if a right to an offset is permitted by contractual agreements. Nevertheless, contingent commission recoverable is reported on *Schedule F - Part 3* of the Annual Statement.

II. Catastrophe premium adjustments

As noted in Part I of this note, the aforementioned asset should only contain ceded reinsurance recoverables on loss payments made by the Company. Recording the catastrophe premium adjustments, the Company had not complied with A/S Instructions and *SSAP No. 62*, paragraph 19, of the AP&P Manual.

The examination determined that the catastrophe premiums adjustments reported in the 2001 A/S, existed as of June 30, 2002. According to the guidance provided by *SSAP No. 4*, paragraph 2, of the AP&P Manual, the said account does not meet the criteria of an asset; consequently, the \$21,882 amount is considered a non-admitted asset for the purposes of this examination and should be charged to operations in the period the transactions occur.

The examination also noted that complete and accurate records on the aforementioned reinsurance transactions were not maintained in accordance with ALA. CODE § 27-27-29(a) (1975). The previous examination had also recommended that the Company maintain complete records in accordance with this statute.

It was noted the Company inaccurately reported the reinsurance recoverables in *Schedule F - Part 3*, and also the aging of the recoverables in *Schedule F - Part 4* of the 2001 A/S. Since the aging of the reinsurance recoverables was inaccurate, *Schedule F - Part 6* and *Part 7* were not correct. The previous examination recommended that *Schedule F* be completed accurately.

It was noted that the Company could not provide certain requested information in accordance with ALDOI Regulation No. 118, which requires the Company to provide a response to requested information within 10 working days.

Note 6 – Federal and foreign income tax recoverable and interest thereon

\$3,565,392

The captioned amount is the same as reported in the Company's *Quarterly Statement as of June 30, 2002*.

It was noted that certain records supporting *Federal and foreign income tax recoverables and interest thereon* were not maintained in the Company's principal office in the State of Alabama, as required by ALA CODE § 27-27-29 (a)(1975), which states, in pertinent part:

“Every domestic insurer shall have, and maintain, its principal place of

business and home office in this state and shall keep therein complete records of its assets, transactions and affairs...”

It was noted that moneys owed to the Company by Kingsway America Inc. (upline parent) as a result of losses or tax credits, were not returned to the Company by the parent within thirty days in accordance with the *Tax Allocation Agreement*.

Note 7 – Guaranty funds receivable or on deposit

\$-0-

The captioned amount is \$662,203 less than the \$662,203 reported in the Company’s *Quarterly Statement as of June 30, 2002*.

The aforementioned consisted of the following accounts:

	ACCOUNT DESCRIPTION	AMOUNT
I.	Alabama insurance guaranty association	\$ 67,784
II.	Louisiana insurance guaranty association	594,419
	TOTAL	<u>\$662,203</u>

I. Alabama insurance guaranty association

Chapter 42, of the *Alabama Insurance Code* is cited as the “Alabama insurance guaranty association act”; the purpose is to assist in the prevention of financial losses to claimants or policyholders for certain covered claims, and in the detection and prevention of insurer insolvencies. The association assesses the cost of such protection among insurers, the amount of which is not greater than one percent of that insurer’s direct written premiums. ALA. CODE § 27-42-8 (1975) allows an insurer to offset its premium tax liability to the extend of twenty percentage of the amount of the assessment for each of the five calendar years following the year in which the assessment was paid. The aforementioned authority does not specify if the \$67,784 in guaranty funds can be carried by the Company as an admitted asset. The examiners concluded that the Company may report the aforementioned amount as an asset, but must not admit the same for the purposes of statutory reporting because such asset is not readily convertible to liquid assets. The \$67,784 deposit also met the definition of a prepaid expense as defined by *SSAP No. 29*, paragraph 2, of the AP&P Manual, which states, in pertinent part:

“A prepaid expense is an amount which has been paid in advance of receiving future economic benefits anticipated by the payment. Prepaid expenses generally meet the definition of assets...[and] nonadmitted

asset as specified in *SSAP No. 4*...Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus).”

Subsequent to the examination period, the Company not admitted the balance of this asset on its *Quarterly Statement as of June 30, 2003*.

II. Louisiana insurance guaranty association

The Company had \$594,419, on deposit with the Louisiana association, and it was reported as admitted by the Company. The examiners determined that the aforementioned deposit did not meet all three characteristics of an asset as defined in *SSAP No. 4*, paragraph 2, of the AP&P Manual, and should be reported as a not admitted asset. It was also noted that all contracts in Louisiana were in run off stages; hence, the asset was considered impaired should have been written-off through the *Statement of Income* in accordance with guidelines established in *SSAP No. 35*, of the AP&P Manual. Said amount was appropriately written-off in the 4th quarter of 2002.

Also see “Guaranty funds receivable or on deposit” in the SUBSEQUENT EVENTS section, elsewhere in this report.

Note 8 – Losses

\$6,804,772

The captioned liability is \$1,852,000 more than the \$4,952,772 reported by the Company in its *Quarterly Statement as of June 30, 2002*.

The actuarial examiners modified normal procedures for reviewing the loss and loss adjustment expenses (LAE) carried as of June 30, 2002, to reflect the mid-year evaluation date of this examination. Standard procedures were performed on the Company’s carried reserves as of December 31, 2001, to establish a benchmark for reserve adequacy and compliance with A/S Instructions. The actuarial examiners then performed an independent review of the Company’s carried reserves as of June 30, 2002, as no reviews were produced by the appointed actuary as of that date.

The actuarial examiners opine that the loss and LAE reserves carried by the Company at the examination date were deficient by \$2,596,981 (approximately 23% of carried surplus), and allocated the amount to the following liability lines:

A/S LINE	ACCOUNT DESCRIPTION	AMOUNT
L1	Losses	\$1,852,000
L3	Loss adjustment expenses [see (Note 9)]	<u>744,981</u>
	TOTAL	<u>\$2,596,981</u>

The examination indicated that the losses and LAE as of June 30, 2002:

- did not meet the requirements of the insurance laws of Alabama;
- were not computed in accordance with accepted loss reserving standards and principles; and
- did not make a reasonable provision for all unpaid loss and loss expense obligations under the terms of its policies and agreements.

The above conclusions were made after the actuarial examiners reviewed the workpapers supporting the reserves as of June 30, 2002, and noted that reliance could not be placed on the workpapers to determine the reasonability of the reserves for several reasons, including:

- The Company provided hard copy worksheets that showed the allocation of paid losses, case reserves, and selected IBNR as of June 30, 2002, to state and line of business. No support for the selected IBNR was included.
- No discussion of Company management's best estimate was provided.

An independent review was performed to determine the reasonableness of the Company's reserves as of June 30, 2002. Workpapers on paid and incurred loss triangles evaluated as of December 31, 2002, were provided by the Company. The last two quarters were removed to obtain the Company's loss triangles as of the June 30, 2002 examination date. The actuarial examiners developed an estimate of ultimate losses and compared the resulting \$6,804,772 to the Company's carried reserves as of June 30, 2002, a \$1,852,000 increase to the liability. Similarly, LAE was increased by \$774,981 from the reported \$1,089,247. Also see "Note 9 – Loss adjustment expenses" and "Note 10 – Commissions payable, contingent commissions, and other similar charges," following in this section.

The actuarial examiners reviewed the rate filings and the Company's product changes critical in addressing the ability of the Company to produce profitable results in its non-standard automobile program. The actuarial examiners concluded that the current rate structure and other Company initiatives to improve short and long term profitability should lead to a much improved book of business once fully implemented.

The actuarial examiners also reviewed the Company's actuarial loss and LAE as of December 31, 2002, and determined that the reserves for *Losses, Loss adjustment expenses* and *Commissions payable, contingent commissions, and other similar charges*, were improved but still deficient at that date. A more detailed discussion of this matter may be found in SUBSEQUENT EVENTS, later in this report, under the "Losses and LAE Reserves" caption.

The paid losses and LAE data captured by the Company's information processing system was obtained for the year 2001, and the six-months ending June 30, 2002. A statistical random sample was selected from the data and verified for accuracy and completeness; the examiners also verified the same for deviation from normal business practices and compliance with insurance laws and regulations. The examiners determined that the sample contained a check issued to a claimant, which was subsequently voided and never replaced. Moneys should be delivered to the rightful owner and the funds not returned to surplus. Any unclaimed funds belonging to claimants in the State of Alabama should be maintained as *Amounts withheld or retained by company for account of others*, and reported as required by ALA. CODE § 35-12-31 (1975), and ALDOI Regulation No. 66.

It was noted that the Company could not provide certain requested information in accordance with ALDOI Regulation No. 118, which requires the Company provide a response within 10 working days. The previous examination made a similar recommendation.

Note 9 – Loss adjustment expenses

\$1,834,228

The referenced liability is \$744,981 more than the \$1,089,247 reported by the Company in its *Quarterly Statement as of June 30, 2002*. The actuarial examiner's conclusions regarding the Company's net loss-related liabilities as of the examination date was a total adjustment of \$5.3 million, thereby accounting for deficiencies in the carried loss and loss expense reserves. Details have been discussed in "Note 8 – Losses," and "Note 10 – Commissions payable, contingent commissions and other similar charges," elsewhere in this section. In addition, information concerning year-end reserves is included under the "Losses and LAE Reserves" caption of SUBSEQUENT EVENTS, later in this report.

The Company treats Defense and Cost Containment Expenses (DCCE) separately from "All Other Expenses" (alternative definitions used are ALAE and ULAE, respectively). The actuary independently reviewed ALAE and ULAE. ALAE was from *Schedule P* and was based on the DCCE definition; ULAE was also from *Schedule*

P and was based on the Other Adjusting Expenses (AO). A review was also conducted to determine if reserves were established for legal actions brought against the Company. The examiners concluded that no reserve had been developed for expenses of litigation on lawsuits known to exist at June 30, 2002. The actuarial examiners determined that the \$524,000 and \$402,000 amounts carried by the Company for DCCE and AO, respectively, were deficient by the aforementioned \$744,981.

It was noted that the Company could not provide all requested information in accordance with ALDOI *Regulation No. 118*, which requires the Company provide a response within 10 working days. The previous examination indicated the same.

**Note 10 – Commissions payable, contingent commissions,
and other similar charges**

\$9,658,953

The referenced liability is \$2,725,386 more than the \$6,933,567 amount reported by the Company in its *Quarterly Statement as of June 30, 2002*.

The examiners reviewed the Company's automobile quota share reinsurance treaties with Kingsway Re, an affiliate, and the related commissions payable accrual. The Company's quota share treaties, both current and prior contracts, contain a sliding scale commission provision. The actuarial examiners reviewed the calculation of the carried value to determine that it was consistent with the terms of the contracts and with the underlying loss experience covered by the contracts. Detailed discussions concerning these contracts may be found in REINSURANCE under the "Reinsurance Ceded" caption.

The Company provided an exhibit showing the development of the carried amounts as of December 31, 2001, and June 30, 2002. The actuarial examiners determined that all of the data reconciled to the financial statements and that the calculations of the commissions payable were consistent with the Company's carried loss and loss expense reserves. However, in order to be consistent with the actuarial examiner's higher estimate of ultimate losses and reserves as of June 30, 2002 (see "Note 8 – Losses," and "Note 9 – Loss adjustment expenses", previously in this section), the actuarial examiners concluded that a higher commissions payable liability should be recorded. The actuarial examiner's estimate effectively assumes that the commissions on the ceded amounts should be booked at the contingent minimum premium, an increase of \$2,725,386.

It was noted that the review of the Company's calculations of the commissions

payable indicated the calculations for treaties 26, and 28, were analyzed in a single calculation, thereby affecting the terms of other agreement years.

Additional information may also be found in the SUBSEQUENT EVENTS section of this report, under the "Losses and LAE Reserves" caption.

Note 11 – Unearned premiums

\$4,908,665

The captioned amount is the same as reported by the Company in its *Quarterly Statement as of June 30, 2002*, but \$42,336 more than the \$4,866,392 amount determined by this examination. Due to immateriality, no changes were made to the financial statements for the purposes of the examination.

The Company's electronic records on unearned premiums reserves were tested during this examination. It was determined that premiums received prior to the effective date on 251 contracts, amounting to \$169,345, were reported as unearned premiums. The said amount when adjusted for reserve credits on reinsurance ceded, calculated to \$42,336 (or 25% of \$169,345). A detail discussion on this matter may be found following in this section under "Note 12 - Advance premium."

It is noted that the examination as of March 31, 2001, reiterated the previous examination recommendation to record unearned premiums when payment is received in advance; the Company had not complied with either recommendation. It is also noted that the recommendation as of March 31, 2001 was to reported advance premium in unearned premiums. The 2002 balance sheet contains a specific line to record advance premium and, as such, the Company should have recorded the same as *Advance premiums*. (See "Note 12 - Advance premium.")

It was noted that the Company could not provide certain requested information in accordance with ALDOI *Regulation No. 118*, which requires the Company provide a response within 10 working days. The previous examination made a similar notation.

Note 12 – Advance premium

\$169,345

The captioned amount is \$169,345 more than the \$-0- reported by the Company in its *Quarterly Statement as of June 30, 2002*.

As noted in "Note 11 – Unearned premiums," the Company reported premiums received prior to the effective date as unearned premiums after adjusting the same for

reserve credits on reinsurance ceded, thereby reducing the overall reserve by \$127,009 [reserve for advance premium of \$169,345, less \$42,336 included in unearned premium reserve]. The Company is required to report premiums received prior to the effective date of the contract as advance premiums in accordance with *SSAP No. 53*, paragraph 13, of the AP&P Manual, which states:

“Advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.”

The Annual Statement convention blank also contains a specific line on the balance sheet for *Advance premium*.

It is noted that the examination as of March 31, 2001, reiterated the previous examination recommendation to report payments received in advance.

Note 13 – Amounts withheld or retained by company
for the account of others

\$ -0-

The captioned amount is the same as reported by the Company in its *Quarterly Statement as of June 30, 2002*, but \$8,757 less than the \$8,757 amount determined by this examination.

The examination determined that \$8,757 in checks issued between January 1, 1997, and December 31, 1997, became escheatable property five years after the moneys were due and payable. Consequently, the checks should have been reported as a liability in accordance with *ALDOI Regulation No. 66*, which requires that:

“All unclaimed funds in the possession, or under the control of an insurer shall, at all times, be maintained as a liability on the books of the insurer. This requirement shall remain in effect until the funds are claimed or transferred to the custody of the State of Alabama...”

Although “outstanding checks” is a liability against the Company’s checking account, the Company should reclassify the unclaimed property over five years due and payable as unclaimed property in accordance with the aforementioned ALDOI regulation. Said liability should be reported under *Amounts withheld or retained by the company for account of others* in accordance with A/S Instructions. Since the \$8,757 amount is just a

reclassification issue, there would be no effect on the Company's surplus; hence, no change to the financial statements was made for the purposes of this report.

The examiners reviewed the unclaimed property filings for the examination period. No filing was made for 2001. It was noted that the Company indicated there were no escheatable funds for that period. ALA. CODE § 35-12-31(d) (1975), states in pertinent part:

“...the reports filed by insurance corporations shall be filed before May 1, of each year as of December 31, next preceding. Any request for postponement must be submitted to the Treasurer, in writing...”

In the event there is no unclaimed property to be reported in a reporting cycle, then the Company should complete REPORT FORM 1, from the State of Alabama's *FORMS AND INSTRUCTIONS FOR REPORTING AND REMITTING UNCLAIMED PROPERTY* booklet in accordance with the aforementioned statute.

It was noted that the filing for the period ended December 31, 2002, was not timely in accordance with Alabama's "Uniform Disposition of Unclaimed Property Act."

Note 14 – Provision for reinsurance

\$50,600

The captioned liability is the same as reported in the Company's *Quarterly Statement as of June 30, 2002*, but \$46,732 less than that determined by the examination. Due to immateriality, no changes were made to the financial statements for the purposes of the examination.

The reserve for *Provision for reinsurance* carried by the Company in the 2001 A/S was verified for accuracy, completeness and regulatory compliance. It was noted that the Company had not maintained complete and accurate verifiable records on reinsurance contracts through EWI RE Inc., an intermediary, in accordance with ALA. CODE § 27-27-29(a) (1975). Also see "Note 5 – Reinsurance recoverable on loss and loss adjustment expense payments." Inaccuracies in *Schedule F*, included but were not limited to the following:

- The reinsurance recoverable from individual reinsurers on paid losses, LAE, and on known case loss reserves were not appropriately reported on *Schedule F - Part 3*. Also see *Part I - Contingent commissions* in "Note 5 – Reinsurance recoverable on loss and loss adjustment expense payments."
- Aging of the reinsurance recoverable in *Schedule F - Part 4* did not agree to the Company workpapers. Reinsurance transactions for the first six months of

2002, including subsequent receipts, were reviewed to determine the over-90-days reinsurance recoverable. The calculated amount was \$306,661, which was \$233,661 more than the \$73,000, utilized by the Company in *Schedule F – Part 7*.

- Due to the errors noted in *Schedule F – Part 4*, *Schedule F – Part 6* was inaccurate, including all calculations in the said schedule.
- *Schedule F – Part 7*, was incorrect, because amounts reported in *Schedule F – Part 3* were carried in said schedule.

All other amounts, other than the reinsurance recoverable over-90-days included in the calculation of *Provision for reinsurance* in the 2001 A/S being the same, the \$46,732, was calculated as follows:

REINSURANCE RECOVERABLE	OVER 90 DAYS	20% OF OVER 90 DAYS
Determined by the examination	\$306,661	\$61,332
Less: <i>Schedule F - Part 7</i> , of the 2001 A/S	73,000	14,600
TOTAL		<u>\$46,732</u>

Note 15 – Payable to parent, subsidiaries and affiliates

\$1,733,690

The captioned amount is \$845,099 more than the \$888,591 reported by the Company in its *Quarterly Statement as of June 30, 2002*.

The Company was operating under a *Management Services and Facilities Agreement* (Agreement) with CIMC, an affiliated company. The Agreement required the Company to reimburse CIMC for commission expenses paid to producing agents, and fees based on an agreed percentage of each calendar month's gross direct and assumed written premium. A detailed discussion of the Agreement may be found earlier in this report in HOLDING COMPANY AND AFFILIATES MATTERS, under the "Transactions and Agreements with Affiliates" caption.

The examiners conducted a review to determine the Company's compliance with the Agreement and with Insurance Holding Company System statutes, as defined by ALA. CODE § 27-29-5 (1975). As a result of the examiners' inquiries, Company management realized that \$845,099 in commission expenses payable to CIMC for the month of January 2001, was erroneously omitted. The examiners determined that the aforementioned commission expenses met the definition of an arm's length transactions per *SSAP No. 25*, and the fair and reasonable standards established by Appendix A-440, of the AP&P Manual. However, the omission resulted in inflation of surplus in the 2001 A/S.

By not recognizing the aforementioned commission expenses, the Company had understated its operating losses and the liability in all its Quarterly Statements in the year 2001, and in the 2001 A/S. Due to the understatement of the operating results, the Company's *Surplus as regards to policyholders* was inflated by \$845,099. Had there been no error in reporting, the Risk-Based Capital would be at Regulatory Action Level (147%) instead of at Company Action Level (181%).

Subsequent to the examination date, Company management corrected the error by recording the \$845,099 amount in expenses and crediting the inter-company account. At June 30, 2002, the transaction had not been remedied; consequently, for the purposes of this examination, the aforementioned amount was included in the captioned liability.

Note 16 - Surplus Notes

\$2,921,250

The referenced liability is the same amount as was reported by the Company at the previous examination date and in its *Quarterly Statement as of June 30, 2002*, and consisted of three surplus notes. All were approved by the Commissioner of the ALDOI in accordance with ALA. CODE § 27-27-40 (1975).

The following table discloses the relevant information concerning each:

	A.	B.	C.
Date Issued	12/31/1991	12/31/1996	12/31/1996
Interest Rate	9.625%	8.250%	8.250%
Amount of Note	\$296,250	\$1,925,000	\$700,000
Carrying Value	\$296,250	\$1,925,000	\$700,000
Interest Paid CY	0	0	0
Total Interest Paid	0	0	0
Accrued Interest	0	0	0
Date of Maturity	None	None	None

- A. Payable to the parent company in monthly installments beginning the first month surplus of the Company exceeds \$2,000,000.
- B. Issued to the parent company in exchange for cash and payable out of earned surplus in excess of \$2,000,000.
- C. Issued to the parent company in exchange for cash and payable out of earned surplus in excess of \$1,637,000.

Payment on each of the notes requires approval of the Commissioner of the ALDOI in accordance with item (d) of the aforementioned section of the *Alabama Insurance*

Code. At the examination date, approval for payment had not been sought, and no interest expense had been accrued on any of the surplus notes.

It was noted that the Company's valuation of these notes was made in compliance with *SSAP No. 41* of the AP&P Manual.

Note 17 – Gross paid in and contributed surplus **\$20,766,200**

The captioned amount is the same as was reported by the Company in its second quarterly filing of 2002. At the previous examination date, *Gross paid in and contributed surplus* was reported as \$9,766,200. Since that time, the amount has increased by \$11,000,000, in increments as follows:

• June 12, 2001	\$1,500,000	
• July 20, 2001	2,000,000	
• December 21, 2001	<u>1,500,000</u>	
<i>Total 2001</i>		\$ 5,000,000
• May 10, 2002	\$1,000,000	
• May 31, 2002	2,000,000	
• June 5, 2002	2,000,000	
• June 28, 2002	<u>1,000,000</u>	
<i>Total 2002</i>		<u>6,000,000</u>
Total Contributions		<u>\$11,000,000</u>

Subsequent to the June 30, 2002 examination period, the Company received six contributions totaling \$15,250,000. Details concerning these contributions may be found in the SUBSEQUENT EVENTS section of the examination report, under the *Capital Contributions* caption. Corroborating documentation for each contribution transaction made since the previous examination was provided by the Company.

Note 18 – Unassigned funds (surplus) **\$(26,798,287)**

Unassigned funds (surplus), as determined by this examination, was \$12,716,230 less than the \$(14,082,057) amount reported by the Company in its *Quarterly Statement as of June 30, 2002*. The following presents a reconciliation of unassigned funds per the Company's filed statement to that developed by this examination:

Unassigned funds (surplus) per Company	<u>\$(14,082,057)</u>
---	------------------------------

Examination increase/(decrease) to assets:

- | | |
|---|-----------------------|
| • Cash and short-term investments (Note 3) | \$ (5,624,911) |
| • Premiums and agents' balances in course of collection (Note 4) | (92,305) |
| • Guaranty funds receivable and on deposit (Note 7) | <u>(662,203)</u> |
| Total increase/(decrease) to assets | <u>\$ (6,379,419)</u> |

Examination (increase)/decrease to liabilities:

- | | |
|--|-----------------------|
| • Losses (Note 8) | \$ (1,852,000) |
| • Loss adjustment expenses (Note 9) | (744,981) |
| • Commissions payable, contingent commissions and other similar charges (Note 10) | (2,725,386) |
| • Advance premium (Note 12) | (169,345) |
| • Payable to parent, subsidiaries and affiliates (Note 15) | <u>(845,099)</u> |
| Total increase/(decrease) to liabilities | <u>\$ (6,336,811)</u> |

Net Increase (Decrease)	<u>(12,716,230)</u>
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Unassigned funds (surplus) per Examination	<u>\$(26,798,287)</u>
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The \$12,716,230 decrease to *Unassigned funds* reduces *Surplus as regards policyholders* to \$(1,610,837), rendering the Company insolvent at the examination date.

CONTINGENT LIABILITIES AND PENDING LITIGATION

The review of contingent liabilities and pending litigation included an inspection of representations made by management, a review of a report to the independent CPAs on pending litigation made by Company counsel, and a general review of the Company's records and files conducted during the examination, including a review of claims. This review did not disclose items that would have a material affect on the Company's financial position in the event of an adverse outcome.

It was noted that the Company did not reserve any funds for legal actions brought against the Company. No reserve had been established for expenses of litigation on lawsuits known to exist at the June 30, 2002 reporting date. Further information concerning DCCE and AO reserving may be found in this report in the NOTES TO

FINANCIAL STATEMENTS section under “Note 8 – Losses,” and “Note 9 – Loss adjustment expenses.”

As was noted previously under the *Transactions and Agreements with Affiliates* caption in HOLDING COMPANY AND AFFILIATE MATTERS, the Company’s affiliate, CIMC, was not licensed as an MGA as required by ALA. CODE § 27-6A-3 (1975), nor as any other person as defined in ALA. CODE § 27-7-1 (1975). In addition, CIMC was not appointed as a producer in accordance with ALA. CODE § 27-7-4(b) (1975). The Company reported earned premiums of \$35,425,978, for the first six months of 2002. Section 27-7-4(a) of the *Alabama Insurance Code*, in pertinent part, provides as follows:

“Any insurer accepting business directly from a person not licensed for that line of authority and not appointed by the insurer shall be liable to a fine of up to three times the premium received from that person.”

In addition, ALA. CODE § 27-7-4.1(a) (1975) states that commission shall not be paid to any person unless that “person holds a current valid license as a producer or service representative.” Item (b) of that statute stipulates that an insurer or producer violating said section “shall be liable for a fine in an amount of up to three times the amount of the commission paid.” Company documentation evidenced \$5,105,823 in paid commissions, as of the June 30, 2002 examination date.

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

A review was conducted during the current examination with regard to the Company’s compliance with recommendations made in the previous examination report. This review indicated that the Company had satisfactorily complied with the prior recommendations with the exception of certain items listed below:

Market Conduct Activities:

Treatment of Policyholders and Claimants – The previous examination report recommended the Company implement and maintain measures to ensure that all claims are promptly investigated, promptly paid, and claimants are promptly notified of denials in accordance with Section 27-12-24, Code of Alabama 1975, as amended. The Company did not comply with this recommendation in its entirety.

It was recommended that the Company implement procedures to ensure that checks

issued for the settlement of claims be distributed to claimants in a timely manner, and further, that the Company monitor the checks issued and outstanding to ensure that checks are provided to claimants in a timely manner. The Company had not complied with this recommendation in its entirety.

It was recommended that the Company take measures to ensure that all estimates utilizing aftermarket crash parts include the disclosure required by Section 32-17A-3, Code of Alabama 1975, as amended. The Company had not complied with this recommendation.

It was recommended that the Company keep and maintain complete records to document claim payments in accordance with Section 27-27-29(a), Code of Alabama 1975, as amended. The Company had not complied with this recommendation.

It was recommended that the Company implement and maintain measures to ensure that all claims are promptly investigated, settled, and paid within reasonable time limits in accordance with Section 27-12-24, Code of Alabama 1975, as amended. While the Company stated that it has implemented service standards to ensure that all claims are promptly investigated, settled and paid within reasonable time limits and all claimants are promptly notified of denials, the Company did not thoroughly execute its new standards.

The recommendations will be repeated in the current *Report of Examination* under the specific captions to which they pertain. (See the COMMENTS AND RECOMMENDATIONS section under the MARKET CONDUCT ACTIVITIES heading, sub caption *Treatment of Policyholders and Claimants*.)

Agents' balances and uncollected premiums – The current examination determined that the Company had not complied with ALDOI *Regulation No. 118*.

Losses and loss adjustment expenses – The current examination determined that the Company had not complied with ALDOI *Regulation No. 118*.

Unearned premiums & Advance premiums – The current examination determined that the Company had not fully complied with the prior examination recommendation when payment received in advance was recorded as unearned premium.

Reinsurance recoverables on loss and loss adjustment expenses – The Company did not comply with the following recommendations:

- *Schedule Fs* was not completed in accordance with the A/S Instructions and AP&P Manual; and

- Complete supporting documentation was not available in accordance with ALA. CODE § 27-27-29(a) (1975).

COMMENTS AND RECOMMENDATIONS

The following summary presents the comments and recommendation that are made in the current *Report of Examination*.

Holding Company and Affiliate Matters

Transactions and Agreements with Affiliates:

Management Services and Facilities Agreement – Page 10

It is recommended that the Company submit all management agreements, service contracts, and cost-sharing arrangements to the ALDOI in accordance with ALA. CODE § 27-29-5 (1975), and ALDOI *Regulation No. 55*.

It is recommended that the Company not pay any fees without an approved management agreement in place and refrain from paying fees, other than submitted and approved dividends, until a management agreement has been approved by the ALDOI in accordance with the aforementioned regulatory authorities.

It is recommended that the Company detail its MGA arrangement with CIMC in a written contract in accordance with ALA. CODE §§ 27-6A-4 and 27-29-5(4) (1975).

It is recommended that the Company license and appoint its MGA, and/or any other person to which commissions are paid, in accordance with ALA. CODE §§ 27-6A-3 and 27-7-4(b) (1975).

It is recommended that the Company pay commissions to only those persons holding a current valid license in accordance with ALA. CODE § 27-7-4.1(a) (1975).

Market Conduct Activities

Treatment of Policyholders and Claimants:

Complaint Handling – Page 19

Complaint log and documentation – Page 19

It is recommended that the Company keep complete and accurate documentation as required by ALA. CODE § 27-27-29(a) (1975) and follow through to ensure that all

complaints are recorded on the complaint log in accordance with Complaint Handling Standard 1 in the NAIC Market Conduct Handbook.

Complaint procedures manual – Page 20

It is recommended that the Company maintain a complaint handling procedures manual and communicate such procedures to policyholders, as defined by Complaint Handling Standard 2 of the NAIC Market Conduct Handbook.

Complaint documentation – Page 20

It is recommended that the Company keep complete records for complaints received from consumers and the ALDOI, in accordance with Complaint Handling Standard 3 of the NAIC Market Conduct Handbook, and ALA. CODE § 27-27-29(a) (1975) for the maintenance of records.

Resolution of complaints – Page 20

It is recommended that the Company respond to all complaint inquiries received by the ALDOI within the 10-day time frame as required by ALDOI *Regulation No. 118*, and within a reasonable time to the complainant.

It is recommended that the Company develop and utilize a policy specifying a reasonable time frame for the timely response and resolution concerning the handling of complaints, per Complaint Handling Standard 4 of the NAIC Market Conduct Handbook.

Subsequent complaints – Page 20

It is recommended that the Company maintain complete records as defined by ALA. CODE § 27-27-29(a)(1975) and log any communication received from the ALDOI on the complaint log in accordance with Complaint Handling standards in the NAIC Market Conduct Handbook.

Policyholder Service – Page 21

Discrepancies of Cancellation methods – Page 21

It is recommended that the Company continue to use the pro rata method of cancellation that was begun on September 22, 1998. When this matter was discussed with Company officials, the Company indicated that it changed to the pro rata method of cancellation in the best interest of the customers. The Company has filed with the ALDOI to correct its underwriting guidelines to reflect the pro rata method for insured requested cancellations, effective April 1, 2003.

Proof of mailing for lien holders – Page 22

It is recommended that the Company monitor the finance company and other agencies to ensure that cancellation notices are being sent on a timely basis to governmental agencies, mortgagees or other third parties, in accordance with ALA. CODE § 27-40-11(d) (1975).

It is recommended that the Company maintain documentation of proof of mailing by the finance company or agencies that mail the cancellation notices to the governmental agency, mortgagee or other third parties as required by ALA. CODE § 27-27-29 (1975), and Policyholder Service Standard 1 of the NAIC Market Conduct Handbook.

Compliance with Agents' Licensing Requirements:

Producer Licensing – Page 24

Producer licenses and appointments – Page 24

It is recommended that the Company monitor its agents on a regular basis to assure that they are properly licensed and appointed as defined in ALA. CODE § 27-7-4(1975) *License requirement*, ALA. CODE § 27-7-30 (1975) *Producer Appointment; termination of appointment*, and Producer Licensing Standards 1 and 2 of the NAIC Market Conduct Handbook. During the course of the examination, Company officials indicated that corrective action would be taken.

Agents' commissions – Page 25

It is recommended that the Company monitor its agents on a regular basis to assure that they are properly licensed and appointed as required by ALA. CODE §§ 27-7-4 *License Requirement*; 27-7-30 *Producer Appointment*; 27-7-29.2 *Assumed business name*; and 27-7-4.1(a) *Commissions*, (1975), ALDOI Bulletin (AB-107) *Agents Doing Business Under Other Names*, and Producer Licensing Standard 2 of the NAIC Market Conduct Handbook.

It is recommended that the Company maintain producer records and correct information in its hard copy and computer data files in accordance with ALA. CODE § 27-27-29(a) (1975) *Maintenance of records*.

Producer Terminations – Page 25

Termination of producers – Page 25

It is recommended that the Company monitor on a regular basis the termination of producers and send proper notification to the producers and the ALDOI as required by ALA. CODE §§ 27-7-30(e), and 27-7-30.1(a) (1975).

Terminated Producer documentation – Page 25

It is recommended that the Company monitor on a regular basis the termination of producers and send proper notification to the producers and the ALDOI, as specified by Producer Licensing Standard 3 of the NAIC Market Conduct Handbook, and ALA. CODE §§ 27-7-30(e) and 27-7-30.1(a) (1975).

Problem Agents/Agencies – Page 26

It is recommended that the Company have a determined way of monitoring agents on a regular basis to assure that they are properly licensed and appointed as required by ALA. CODE § 27-7-4 (1975) *License Requirement*, ALA. CODE § 27-7-30 (1975) *Producer Appointment*, and Producer Licensing Standard 2 of the NAIC Market Conduct Handbook. Subsequent to the June 30, 2002 examination period, Company officials indicated that corrective actions have been taken to improve the monitoring and maintenance of producers.

It is recommended that the Company maintain complete and accurate records as required by ALA. CODE § 27-27-29(a) (1975) for its hard copy and computer data files.

Underwriting and Rating:

Active Policies – Page 26

Rating Practices and Underwriting Practices – Pages 26 and 28

It is recommended that the Company charge rates for policy coverage based on rates filed in accordance with ALA. CODE §§ 27-2-17, 27-13-4 (1975), ALA. ADMIN. CODE 482-1-123 (2001), the March 31, 2001 Bulletin, and Underwriting and Rating Standard 11 of the NAIC Market Conduct Handbook.

It is recommended that the Company maintain complete records of its underwriting transactions and affairs for at least five years in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, and Underwriting and Rating Standard 15 of the NAIC Market Conduct Handbook.

Cancelled/Terminated Policies – Page 29

First Sixty Days Cancellations – Page 29

It is recommended that the Company maintain complete records of its underwriting transactions and affairs in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, and the Company's U/W Manual.

It is recommended that the Company provide the correct reasons for cancellation on all notices of cancellation in accordance with policy provisions, state laws, Company guidelines, and relevant NAIC Underwriting and Rating Standards.

Non-renewals and Cancellations of Sixty Days or More – Page 31

It is recommended that the Company maintain complete records of its underwriting transactions and affairs in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, the Company's U/W Manual, and applicable NAIC Underwriting and Rating Standards.

Claims Payment Practices:

Paid Claims – Page 32

Timely Communications – Page 32

It is recommended that the Company insure that initial contact by the Company with the claimant is within the required time frame in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003), and Claims Standard 1 of the NAIC Market Conduct Handbook.

It is recommended that the Company insure that it responds to pertinent claims communications in a timely manner in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003), and Claims Standard 4 of the NAIC Market Conduct Handbook.

Timely Resolutions – Page 33

It is recommended that the Company insure that its claims resolutions, i.e., liability determinations, coverage questions, claim payments, etc., are made in accordance with the relevant sections of ALA. ADMIN. CODE 482-1-125 (2003), and Claims Standards 2 and 3 of the NAIC Market Conduct Handbook.

Adequate file documentation – Page 34

It is recommended that the Company maintain complete and accurate records of its claims transactions in accordance with ALA. CODE § 27-27-29 (1975), ALDOI

Regulation No. 118, and Claims Standard 5 of the NAIC Market Conduct Handbook. This recommendation was also made in the previous examination report. ALA. ADMIN. CODE 482-1-125-.04 (2003) also defines the maintenance of claims files so that data is accessible and retrievable for examination purposes.

It is recommended that the Company account for and properly document its replacement check and voided check transactions in accordance with ALA. CODE § 27-36-1 (1975), *SSAP No. 5*, of the AP&P Manual, the A/S Instructions, and SUFI's "Transactions Types" guidelines.

It is also recommended that unclaimed property (including claims checks) be reported as *Amounts withheld by company for account of others*, and escheated to the State of Alabama in accordance with ALA. CODE § 35-12-31 (1975), ALDOI *Regulation No. 66*, and A/S Instructions.

Paid Claims – Based on policy provisions, ALDOI statutes, etc. – Page 35

It is recommended that the Company maintain complete and accurate records of its claims transactions in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, and Claims Standards 6 and 12 of the NAIC Market Conduct Handbook. ALA. ADMIN. CODE 482-1-125-.04 (2003) also defines the maintenance of claims files so that data is accessible and retrievable for examination purposes.

It is recommended that the Company include the disclosure statement regarding non-original equipment manufacturer aftermarket crash parts with its written estimates in accordance with ALA. CODE § 32-17A-3 (1975). This recommendation was also made in the previous examination report.

It is recommended that the Company account for and properly document its replacement check and voided check transactions in accordance with ALA. CODE § 27-36-1 (1975), *SSAP No. 5*, of the AP&P Manual, the A/S Instructions, and SUFI's "Transactions Types" guidelines.

It is also recommended that unclaimed property (claims checks) be reported as *Amounts withheld or retained by company for account of others*, and escheated to the State of Alabama in accordance with ALA. CODE § 35-12-31 (1975), ALDOI *Regulation No. 66*, and A/S Instructions.

Denied Claims – Page 36

Acknowledgement of Pertinent Communications – Page 36

It is recommended that the Company insure that initial contact by the Company with the claimant is within the required time frame in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003), and Claims Standard 1 of the NAIC Market Conduct Handbook.

It is recommended that the Company insure that it responds to pertinent claims communications in a timely manner in accordance with ALA. ADMIN. CODE Chapters 482-1-125-.06, and 482-1-125-.07 (2003), and Claims Standard 4 of the NAIC Market Conduct Handbook.

Claims denied or closed-without-payment –

Adequate file documentation – Page 37

It is recommended that the Company maintain complete and accurate records of its denied and/or closed-without payment claims files and transactions in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, policy provisions, and Claims Standards 5 and 11 of the NAIC Market Conduct Handbook. ALA. ADMIN. CODE 482-1-125-.04 (2003) also defines the maintenance of claims files so that data is accessible and retrievable for examination purposes.

Accounts and Records – Page 45

It is recommended that the Company provide all requested information to the examiners in a timely manner in accordance with ALDOI *Regulation No. 118*.

Bonds – Page 52

It is recommended that the Company amortize its bonds to the call or maturity value/date in accordance with the *SSAP No. 26*, Section 6, of the AP&P Manual.

It is recommended that the Company use the scientific (constant yield) interest method in accordance with *SSAP No. 26*, Section 6, of the AP&P Manual.

Real estate – Page 52

It is recommended that the Company keep updated appraisals for properties that are

admitted as assets in accordance with ALA. CODE § 27-37-7(b) (1975), and *SSAP No. 40*, paragraph 12, of the AP&P Manual. If the Company chooses to admit the Commercial Rental Property, a new appraisal should be obtained for said property.

It is recommended that the Company keep complete records including original cost records for all properties owned by the Company in accordance with ALA. CODE § 27-27-29(a) (1975).

It is recommended that the Company keep and maintain all vouchers for any disbursement of \$25.00 or more in accordance with ALA. CODE § 27-27-30(a) (1975).

Cash and short-term investments – Page 54

It is recommended that the Company refrain from investing its cash in excess of the statutory limitation, as required by ALA. CODE § 27-41-6(a) (1975). Any amount exceeding such guidelines should be not admitted from the balance sheet.

It is recommended that the Company ensure the collateral pledged for the repurchase agreement meets the requirements of *SSAP No. 45* of the AP&P Manual by equaling 102 percent of the purchase price of the underlying security.

It is recommended that the Company report its repurchase agreement transactions under the Investment section of the *General Interrogatories* as required by the A/S Instructions.

It is recommended that the Company properly identify its investments in the appropriate Annual Statement schedules in accordance with NAIC instructions thereto and ALA. CODE § 27-37-1 (1975).

Agents' balances or uncollected premiums:

Premiums and agents' balances in course of collection – Page 55

It is recommended that the Company comply with the definition of uncollected premiums in accordance with A/S Instructions and *SSAP No. 6*, of the AP&P Manual.

It is recommended that uncollected premiums that do not meet the criteria of admitted assets, as defined by *SSAP No. 4* of the AP&P Manual, be not admitted

from the balance sheet.

Reinsurance recoverables on loss and loss adjustment expenses – Page 57

It is recommended that the Company maintain complete records of its transactions and affairs in accordance with ALA. CODE § 27-27-29(a) (1975).

It is recommended that the Company properly account for overdue recoverables from authorized insurers and report such items in the appropriate part of *Schedule F* in accordance with A/S Instructions, and *SSAP No. 62*, paragraph 19, of the AP&P Manual. The previous examination also made the above recommendations.

It is recommended that the Company not include any other asset other than reinsurance recoverables on loss payments in the referenced line in accordance with A/S Instructions, and *SSAP No. 62*, paragraph 19, of the AP&P Manual.

Federal and foreign income tax recoverable and interest thereon – Page 58

It is recommended that the Company comply with ALA CODE § 27-27-29 (a) (1975), and maintain all records pertaining to the Company's operation at its home office within the State of Alabama.

It is also recommended that the Company comply with all aspects of its *Tax Allocation Agreement* and return moneys owed to the Company in accordance with said agreement.

Guaranty funds receivable or on deposit – Page 59

It is recommended that the Company report guaranty funds in accordance with ALA. CODE § 27-42-8 (1975), and *SSAP No's. 4, 29 and 35*, of the AP&P Manual.

Losses – Page 60

Loss adjustment expenses – Page 62

It is recommended that the Company insure that its reported losses and LAE reserves:

- meet the requirements of the insurance laws of Alabama;

- are computed in accordance with accepted loss reserving standards and principles; and
- make a reasonable provision for all unpaid loss and loss expense obligations under the terms of its policies and agreements.

It is recommended that the Company maintain adequate documentation that supports management's selected reserves as presented in the Company's financial statements in accordance with ALA. CODE §§ 27-27-29, and 27-37-1 (1975), *SSAP No. 55*, of the AP&P Manual, and A/S Instructions.

**Commissions payable, contingent commissions,
and other similar charges** – Page 63

It is recommended that the Company calculate its contingent liability related to the sliding scale commission arrangements in its reinsurance contracts by treaty and by agreement year in order to insure that the results by agreement years do not affect the terms of the other agreement years in accordance with ALA. CODE § 27-36-1 (1975) and *SSAP No. 55*, of the AP&P Manual.

Unearned premiums – Page 64

Advance premium – Page 64

It is recommended that the Company report premiums processed and paid prior to the effective date as *Advance premium* and not *Unearned premiums* in accordance with *SSAP No. 53*, of the AP&P Manual and A/S Instructions. It is also noted that the previous examination recommended that the Company record unearned premiums when the payments are received in advance; therefore, that recommendation is reiterated.

Amounts withheld or retained by company for account of others – Page 65

It is recommended that the Company establish and maintain a liability for unclaimed property until the appropriate time frame has elapsed to remit said funds to the Alabama Department of Revenue, in accordance with ALDOI *Regulation No. 66*.

It is recommended that the Company file the unclaimed property report timely in accordance with ALA. CODE § 35-12-31(d) (1975). **It is also recommended** that

the Company file REPORT FORM 1 in the event there is no unclaimed property to be reported in a reporting cycle.

Provision for reinsurance – Page 66

It is recommended that the Company maintain complete records of its transactions and affairs in accordance with ALA. CODE § 27-27-29(a) (1975).

It is recommended that the Company properly account for overdue recoverables from authorized insurers and report such items in the appropriate part of *Schedule F* in accordance with A/S Instructions, and *SSAP No. 62*, paragraph 19, of the AP&P Manual. The previous examination also made above recommendations.

It is recommended that the Company not include any other asset other than reinsurance recoverables on loss payments in *Provision for reinsurance* in accordance with A/S Instructions and *SSAP No. 62*, paragraph 19, of the AP&P Manual.

Payable to parent, subsidiaries and affiliates – Page 67

It is recommended that the Company comply with ALA. CODE § 27-27-29 (1975), and *SSAP No. 25*, of the AP&P Manual by appropriately recording and reporting intercompany expenses.

Compliance with ALDOI Regulation No. 60

It is recommended that the Company file future Annual and Quarterly Statements in accordance with the last filed *Report of Examination*, pursuant to ALDOI Regulation No. 60, and the ALDOI *Bulletin*, dated January 26, 2000 (Accounting Practices and Procedures Required for Authorized Insurers).

SUBSEQUENT EVENTS

Directors and Officers

As noted in the MANAGEMENT AND CONTROL section of this report, several of the Company's directors and officers resigned subsequent to June 30, 2002. The Company's officers at the date of this report are as follows:

- President – William Gabriel Star
- Executive Vice President and COO – Richard Day Murray
- Vice President and Secretary – Richard Wesley Bird
- Treasurer and CFO – Carrie Renee Harper

Richard Day Murray replaced Craig Lochner on the Board of Directors.

Risk-Based Capital (RBC)

A review of the carried loss and LAE reserves in the December 31, 2002 Annual Statement (2002 A/S), was made by the Department's consulting actuaries (actuaries), as requested by the Chief Examiner of the ALDOI. Based on the review of the workpapers provided by the Company's opining actuary, the loss and LAE reserves of \$8,104,034 were found to be deficient. An independent estimate by the actuaries determined that the loss and LAE reserves were deficient by \$1,012,000, and the contingent commissions liability deficient by \$19,000. *Surplus as regards to policyholders* in the 2002 A/S, was reported to be \$13,783,814; adjustments of \$1,031,000 [$\$1,012,000 + \$19,000$] will reduce the *Surplus as regards policyholders* and the TAC to \$12,752,814.

Review of the Company's 2002 A/S indicated that the initial TAC was \$13,783,814, and the ACLR \$6,614,690. The calculated RBC was 208%, or at Adequate Level according to the Model Act.

Upon request from the NAIC, an amended RBC report was filed by the Company. The TAC was the same; changes made in the report decreased the ACLR to \$6,447,317. The amended RBC was 214%, or at Adequate Level.

Consequently, as of December 31, 2002, the ratio of the TAC of \$12,752,814 to the amended ACLR of \$6,447,317, put the RBC at an elevated level of 198%, or at Company Action Level. However, a review of the data reported in the Company's *Annual Statement as of December 31, 2003*, indicated that the TAC was \$19,118,858, and the ACLR was \$3,497,561. Accordingly, the calculated RBC was 547%, which is Adequate Level according to the Model Act.

Cash and short-term investments

It was noted that at December 31, 2002, the Company's investments in Whitney Bank still exceeded the investment limitations as defined in ALA. CODE § 27-41-6(a) (1975). At March 31, 2003, however, details concerning these investments established

that the Company was then in compliance with the aforementioned section of the *Alabama Insurance Code*.

Guaranty funds receivable or on deposit

The \$594,419 balance at June 30, 2002, for the Louisiana insurance guaranty association was written-off in the 4th quarter of 2002. The \$60,254 balance reported on page 2, line 16, of the 2002 Annual Statement represented the remaining balance of the assessment carried in the books for the Alabama insurance guaranty association. The remaining \$52,724 balance was not admitted in the Company's *Quarterly Statement as of June 30, 2003*.

Losses and Loss adjustment expenses

The actuarial examiners reviewed the Company's actuarial loss and LAE data as of December 31, 2002, and determined that the amounts for *Losses* and *Loss adjustment expenses* were deficient. The table below summarizes the Company's carried liabilities, the actuarial examiner's independent estimate of those liabilities, and the appointed actuary's estimates as documented in his actuarial report:

Loss and LAE Reserves (\$000) at December 31, 2002

	<u>Direct and Assumed</u>	<u>Net</u>
Carried	\$ 31,534	\$ 8,104
<u>ALDOI actuaries' estimate</u>	<u>34,519</u>	<u>9,116</u>
Deficiency	<u>\$ (2,985)</u>	<u>\$ (1,012)</u>
	- 8.6%	- 11.1%
 <u>Appointed actuary's estimate</u>	 <u>\$ 32,219</u>	 <u>\$ 8,541</u>
Deficiency	<u>\$ (685)</u>	<u>\$ (437)</u>
	- 2.1%	- 5.1%

The appointed actuary concluded that the Company's carried reserves were within a range of reasonable reserve estimates. The Company did not book the actuary's best estimate, as listed above.

The Company strengthened reserves in 2002, most significantly for the 2001 accident year. The Company experienced high growth in 2001, and the initial reserves

established as of December 31, 2001, were based on optimistic assumptions regarding a priori loss ratios and loss development factors. In the analysis as of December 31, 2002, the appointed actuary increased his estimate of the ultimate 2001 loss and LAE, as did the Company. It is the actuarial examiner's opinion that further adverse development will occur on the current carried reserves for 2001, as well as accident years 1999, 2000, and 2002, as the appointed actuary continues to utilize overly optimistic assumptions regarding the selected loss development factors and a priori loss ratios used in this analysis.

In addition, the actuarial examiners estimated the liability for commissions payable as of December 31, 2002, to be \$12,798,307. The Company's carried liability in the 2002 Annual Statement was \$12,779,000, with a deficiency of approximately \$19,000. This amount was not deemed to be material, and no adjustment to the carried amount was recommended.

Capital Contributions

The Company requested permission under *SSAP No. 9* and *SSAP No. 72* of the AP&P Manual, to make post December 31, 2002 surplus contributions that would be reflected on the Company's 2002 Annual Statement. Permission for a permitted practice was granted by the Commissioner of the ALDOI on February 10, 2003, and the \$3 million in contributions were reflected in the annual filing.

On June 27, 2003, the ALDOI was informed that Kingsway America, Inc., intended to make a \$5 million capital contribution, which was expected to count as surplus on the Company's second quarter statutory financial statements. Permission to make a post June 30, 2003 surplus contribution was granted and approved by the Commissioner of the ALDOI under *SSAP No. 9* and *SSAP No. 72* of the AP&P Manual. The funds were reflected in the 2nd Quarter 2003 filing.

The following is an itemized schedule reflecting the capital contributions made subsequent to the June 30, 2002 examination date:

October 31, 2002	Kingsway contributed \$3,500,000 additional paid in capital thereby increasing <i>Gross paid in and contributed surplus</i> to \$24,266,200 at quarter ended October 31, 2002.
December 24, 2002	Kingsway contributed \$3,750,000 additional paid in capital thereby increasing <i>Gross paid in and contributed surplus</i> to

\$28,016,200 at year ended December 31, 2002. [See *.]

February 5, 2003	Kingsway contributed \$800,000, \$200,000, and \$2,000,000,
February 5, 2003	respectively, which were reflected on the Company's 2002
February 24, 2003	A/S. <i>Gross paid in and contributed surplus</i> thereby increased to
	\$31,016,200* at year-end 2002.
June 30, 2003	Kingsway contributed \$5,000,000 additional paid in capital
	thereby increasing <i>Gross paid in and contributed surplus</i> to
	\$36,016,200 at quarter ended June 30, 2003.

Show Cause Orders

"Show Cause" notice orders issued on May 3, 2002 and May 31, 2002, were "LIFTED" on July 11, 2002 by an order from the Commissioner of the ALDOI. The orders were lifted because the Company corrected the deficiency and maintained the capital and surplus above the requisite minimum requirements.

An *Order to Show Cause* was issued on January 28, 2003, by the ALDOI Commissioner of Insurance in accordance with ALA. ADMIN. CODE 101 (1994), as the Company was determined to be "operating in a hazardous financial condition." Additional capital infusions by Kingsway (as noted in the table above) were made in response to this action in order to cure the condition.

CONCLUSION

Acknowledgement is hereby made of the courteous cooperation extended by all persons representing the Company during the course of this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and evaluation of assets and determination of liabilities set forth in this report.

The Company did not provide all requested information to the examiners in accordance with ALDOI *Regulation No. 118*. Details of the noted problems may be found in the NOTES TO FINANCIAL STATEMENTS section of this report, under the various captions to which they relate. In addition, as a result of findings determined by this examination, the Company was financially insolvent at the June 30, 2002 examination date. See the SUBSEQUENT EVENTS section of this report for corrective actions taken by the Company.

In addition to the undersigned, F. Blase Abreo, Thomas Dan Norton and Angeline Wages, Examiners; Mark L. Brannon, FCAS, MAAA, CPCU, Consulting Actuarial Examiner; and Linda Dykes, Consulting Market Conduct Examiner; all representing the Alabama Department of Insurance, participated in this examination of *Southern United Fire Insurance Company*.

Respectfully submitted,



Anne L. Ward, AFE
Examiner-in-Charge
State of Alabama
Department of Insurance

January 26, 2004

**EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES
USED IN AN EXAMINATION**

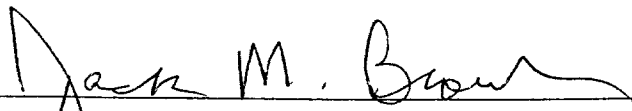
STATE OF ALABAMA

COUNTY OF MONTGOMERY

Jack M. Brown, being duly sworn, states as follows:

1. I have authority to represent the State of Alabama in the examination of Southern United Fire Insurance Company, Mobile, Alabama.
2. The Alabama Department of Insurance is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination workpapers and examination report, and the June 30, 2002 examination of Southern United Fire Insurance Company, Mobile, Alabama, was performed in a manner consistent with the standards and procedures required by the State of Alabama Department of Insurance, and the National Association of Insurance Commissioners.

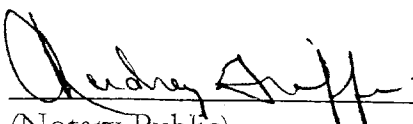
The affiant says nothing further.



Jack M. Brown, CFE, CIE
Assistant Chief Examiner, and Insurance Examinations Supervisor
State of Alabama, Department of Insurance

Subscribed and sworn before me by Jack M. Brown,
on this 26th day of January, 2004.

(SEAL)



(Notary Public) My commission expires 11/2/05
(Date)



DON SIEGELMAN
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
POST OFFICE BOX 303351
MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 269-3550
FACSIMILE: (334) 241-4192
INTERNET: www.aldoi.org

D. DAVID PARSONS
COMMISSIONER
ASSISTANT COMMISSIONER
TREY-GRANGER
DEPUTY COMMISSIONER
JAMES R. (JOHNNY) JOHNSON
CHIEF EXAMINER
RICHARD L. FORD
STATE FIRE MARSHAL
JOHN S. ROBISON
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

June 27, 2002

Craig A. Lochner
President
Southern United Fire Insurance Company
One Southern Way
Mobile, AL 36619

Re: Financial Examination As Of June 30, 2002

Dear Mr. Lochner:

This letter is to inform you of a financial examination of your company called by the Alabama Department of Insurance and to authorize Anne L. Ward, AFE, Examiner, to conduct the examination. This authorization is pursuant to the instructions of Alabama Insurance Commissioner, D. David Parsons, and in compliance with the statutory requirements of the State of Alabama and resolutions adopted by the National Association of Insurance Commissioners.

Your examination is to commence on or about August 5, 2002, and will be conducted primarily in your offices. The expected duration of the examination is approximately four months. Preliminary planning of your examination will first begin in the offices of the Alabama Department of Insurance. The examiner will arrive in your offices on or after this date. You will be contacted by Ms. Ward regarding the exact arrival date at your offices.

The Alabama Insurance Department has adopted work policies and rules governing work hours, leave and unacceptable conduct including sexual harassment. If you have any question about our examiner's conduct at your offices, please contact me immediately.

As part of your examination, the enclosed internal control and information systems questionnaire is required to be completed for review by our examiner. Please complete and return the questionnaire to this Department within 30 days, addressed to the attention of the Examiners' Division. The questions may be answered on the questionnaire itself or on a separate sheet if additional explanation is required. If possible, your CPA's workpapers and a representative of your CPA firm should be available the week of August 5, 2002, for review at your offices.

Invoices covering examination fees and related expenses will be submitted to the appropriate company official in accordance with standard Departmental policy. Payment of any examination charges so invoiced are due within two business days following presentation of the invoice.

Sincerely,

Richard L. Ford, CFE
Acting Deputy Commissioner and
Chief Examiner

RLF:dk

Enclosures

cc: Jack M. Brown, CFE
Anne L. Ward, AFE
Ken Smithson

EQUAL OPPORTUNITY EMPLOYER

SENDER: COMPLETE THIS SECTION

- Complete items 1, 2, and 3. Also complete item 4 if Restricted Delivery is desired.
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- Attach this card to the back of the mailpiece, or on the front if space permits.

1. Article Addressed to:

Craig A. Lochner
President
Southern United Fire Ins Co
One Southern Way
Mobile, AL 36619

COMPLETE THIS SECTION ON DELIVERY

A. Received by (Please Print Clearly)

B. Date of Delivery

C. Signature

x *Alvin Jones*☐ Agent☐ Addressee

D. Is delivery address different from item 1?

☐ Yes

If YES, enter delivery address below:

☐ No

3. Service Type

☒ Certified Mail☐ Express Mail☐ Registered☒ Return Receipt for Merchandise☐ Insured Mail☐ C.O.D.

4. Restricted Delivery? (Extra Fee)

☐ Yes

2. Article Number (Copy from service label)

7099 3400 0015 2329 4855

PS Form 3811, July 1999

Domestic Return Receipt

102595-00-M-0952



DON SIEGELMAN
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
POST OFFICE BOX 303351
MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 269-3550
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JOHN S. ROBISON
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

June 27, 2002

Mr. Matthew P. Merlino
Merlino & Schofield, Inc. Associates Inc.
3060 Holcomb Bridge Road, NW, Suite J
Norcross, GA 30071

Re: Examination of Southern United Fire Insurance Company
As of June 30, 2002

Dear Mr. Merlino:

This letter is to request and authorize your participation in the examination of the above referenced company for the purpose of computing reserves and making other valuations in your usual manner.

The examination will begin on or about August 5, 2002. The examination for this company is being conducted in the company's offices at One Southern Way, Mobile, AL 36619, and will cover the period ending June 30, 2002. The expected duration of the examination is approximately four months.

The Examiner-in-Charge will be Ms. Anne L. Ward, AFE. Please contact her at the company after the beginning date to coordinate the scheduling of your portion of this examination. The company telephone number is (251) 661-8008.

If your schedule does not permit you to accept this assignment, please let me know so that other arrangements can be made.

Thank you for your assistance in this matter.

Sincerely,


Richard L. Ford, CFE
Acting Deputy Commissioner and
Chief Examiner

RLF:dk

cc: Jack M. Brown, CFE
Anne L. Ward, AFE
Ken Smithson

SENDER: COMPLETE THIS SECTION

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- Print your name and address on the reverse so that we can return the card to you.
- Attach this card to the back of the mailpiece, or on the front if space permits.

1. Article Addressed to:

Mr. Matthew P. Merlino *Associates*
Merlino & ~~Schiff~~ *Inc.*
*3060 Holcomb Bridge Road NW
Suite J
Norcross GA 30071

2. Article Number (Copy from service label)

7099 3400 0015 2327 4879

PS Form 3811, July 1999

Domestic Return Receipt

102595-00-M-0952

COMPLETE THIS SECTION ON DELIVERY

A. Received by (Please Print Clearly) B. Date of Delivery

Mark L. Brannon

7/5/02

C. Signature

X

Mark L. Brannon

☐ Agent☐ Addressee

D. Is delivery address different from item 1?

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3. Service Type

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4. Restricted Delivery? (Extra Fee)

☐ Yes



DON SIEGELMAN
GOVERNOR

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DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
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JOHN S. ROBISON
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

June 27, 2002

Mr. J. R. (Bob) Carlisle
Insurance Logic, Inc.
402 Foxhall Road
Pike Road, AL 36064

Re: Examination of Southern United Fire Insurance Company
As of June 30, 2002

Dear Mr. Carlisle:

This letter is to request and authorize your participation in the market conduct portion of the examination of the referenced company.

The examination will begin on or about August 5, 2002. The examination for this company is being conducted in the company's offices at One Southern Way, Mobile, AL 36619, and will cover the period ending June 30, 2002. The expected duration of the examination is approximately four months.

The Examiner-in-Charge will be Ms. Anne L. Ward, AFE. Please contact her at the company after the beginning date to coordinate the scheduling of your portion of this examination. The company telephone number is (251) 661-8008.

If your schedule does not permit you to accept this assignment, please let me know so that other arrangements can be made.

Thank you for your assistance in this matter.

Sincerely,

Richard L. Ford, CFE
Acting Deputy Commissioner and
Chief Examiner

RLF:dk

cc: Jack M. Brown, CFE
Anne L. Ward, AFE
Ken Smithson

SENDER: COMPLETE THIS SECTION

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1. Article Addressed to:

Mr. J. R. (Bob) Carlisle
Insurance Logic Inc.
402 Foxhall Road
Pike Road, AL 36064

COMPLETE THIS SECTION ON DELIVERY

A. Received by (Please Print Clearly) B. Date of Delivery

J R Carlisle 7/17/06

C. Signature

X

J R Carlisle

☐ Agent☐ AddresseeD. Is delivery address different from item 1? ☐ YesIf YES, enter delivery address below: ☐ No

3. Service Type

☒ Certified Mail☐ Express Mail☐ Registered☒ Return Receipt for Merchandise☐ Insured Mail☐ C.O.D.

4. Restricted Delivery? (Extra Fee)

☐ Yes

2. Article Number (Copy from service label)

7099 3400 0015 2327 6606

PS Form 3811, July 1999

Domestic Return Receipt

102595-00-M-0952

Copied to Anne Ward ✓



MERLINOS & ASSOCIATES, INC.

Fax Transmittal Form

To: A.J. Bowab

From: Mark Brannon

Fax No: (334) 662-6562

Total Pages Faxed: 2

Date: September 6, 2002

Time Sent: 2:55 pm

Message:

RE: Southern United Fire Insurance Company

CC: Anne Ward, Alabama DOI (334) 241-4192

MERLINOS & ASSOCIATES, INC.

3060 Holcomb Bridge Road, NW, Suite J, Norcross, Georgia 30071
Phone: (770) 453-9790 Fax: (770) 453-9619 Email: mbrannon@merlinosinc.com

WARNING: This fax message and any attached files contain information intended for the exclusive use of the individual or entity to whom it is addressed and may contain information that is proprietary, privileged, confidential and/or exempt from disclosure under applicable law. If you are not the intended recipient, you are hereby notified that any viewing, copying, disclosure or distribution of this information may be subject to legal restriction or sanction. Please notify the sender, by phone, of any unintended recipients and delete the original message without making any copies.

MERLINOS & ASSOCIATES, INC.
ACTUARIES AND CONSULTANTS

MATTHEW P. MERLINO, FCAS, MAAA, FCA
PAUL M. MERLINO, ACAS, MAAA
MARK L. BRANNON, FCAS, MAAA, CPCU
DAVID M. SHEPHERD, FCAS, MAAA
PETER A. SCOURTIS, ACAS, MAAA
ROSEMARY G. WICKHAM, ACAS, MAAA

September 6, 2002

VIA FACSIMILE: (334) 662-6562

Mr. A. J. Bowab, CPA
Southern United Fire Insurance Company
One Southern Way
Mobile, AL 36619

RE: Southern United Fire Insurance Company
Financial Examination as of 6/30/2002
Alabama Department of Insurance

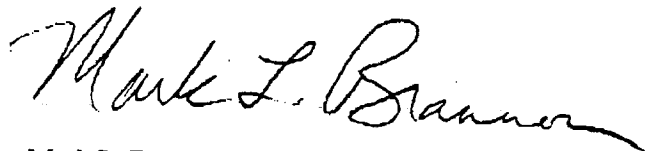
Dear Mr. Bowab:

We have been requested to assist the Alabama Department of Insurance with the financial examination of Southern United Fire Insurance Company. In order to initiate our work on the financial examination, we request the following documentation:

1. 12/31/01 Statutory Annual Statement and Statement of Actuarial Opinion;
2. Actuarial report and/or workpapers in support supporting the 12/31/01 Actuarial Opinion;
3. The 3/31/02 and 6/30/02 Quarterly Statements;
4. Management Discussion and Analysis for 12/31/01;
5. Copies of any applicable Reinsurance Treaties in place in 2001;
6. Listing of all rate changes implemented since January 1, 2001 by state.
7. List of planned rate activity for the remainder of 2002.

Please send these via overnight delivery to the address below. Thank you for your assistance. Please give me a call if you have any questions.

Sincerely,



Mark L. Brannon, FCAS, MAAA, CPCU

CC: Anne Ward, Alabama Department of Insurance

3060 HOLCOMB BRIDGE ROAD, NW, SUITE J, NORCROSS, GEORGIA 30071
PHONE: (770) 453-9790 FAX: (770) 453-9619 EMAIL: MERLINOS@MERLINOSINC.COM



DON SIEGELMAN
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
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MONTGOMERY, ALABAMA 36130-3351
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STATE FIRE MARSHAL
JOHN S. ROBISON
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

October 7, 2002

Laurie Bowers
KPMG
Financial Center
505 20th Street North, Suite 1200
Birmingham, AL 35203-2674

Re: Request for CPA Workpapers in June 30, 2002 Examination of Southern United
Fire Insurance Company


Dear Ms. Bowers:

We received your letter regarding the request for inspection of the workpapers prepared in the referenced examination.

The request to inspect the workpapers is made by your client pursuant to Section 13 of Regulation 100. The letter of qualification your firm provided your insurer client should consent and agree to make available for review by the Commissioner, his designee or his appointed agent, the workpapers prepared in your examination. This agreement and consent is required by Section 12 of Regulation 100. Any copies of your firm's workpapers included in the Department's files will remain confidential to the extent provided under Alabama law.

If you have any questions, please advise.

Sincerely,


Jack M. Brown, CFE, CIE
Assistant Chief Examiner

cc: Richard Ford, CFE, CIE
Anne L. Ward, AFE, Examiner-in-charge

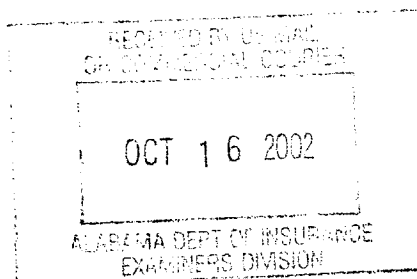
EQUAL OPPORTUNITY EMPLOYER



Financial Center, Suite 1200
Birmingham, AL 35203

Telephone 205 324 2495
Fax 205 324 3084

October 2, 2002



Mr. Jack Brown
Alabama Department of Insurance
201 Monroe Street Suite 1700
Montgomery, Alabama 36130-3351

Dear Mr. Brown

Your representatives have requested access to our workpapers in connection with our audit of the December 31, 2001, statutory financial statements of Southern United Fire Insurance Company. It is our understanding that the purpose of your request is to facilitate your regulatory examination. Management of Southern United Fire Insurance Company has authorized us to provide you access to our workpapers for your examination.

Our audit of Southern United Fire Insurance Company's December 31, 2001, statutory financial statements was conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is to form an opinion as to whether the financial statements, which are the responsibility and representations of management, present fairly, in all material respects, the admitted assets, liabilities and surplus, results of operations and cash flows of Southern United Fire Insurance Company in conformity with accounting practices prescribed or permitted by the Alabama Department of Insurance. Under auditing standards generally accepted in the United States of America, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected. In addition, those standards require the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of fieldwork and reporting.

The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and as to the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Thus, our audit based on the concept of selective testing, is subject to the inherent risk that material errors or fraud, if they exist, would not be detected. In addition, an audit does not address the possibility that material errors or fraud may occur in the future. Also, our use of professional



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a member of KPMG International, a Swiss association.



Mr. Jack Brown
Alabama Department of Insurance
October 2, 2002
Page 2

judgment and the assessment of materiality for the purpose of our audit means that matters may have existed that would have been assessed differently by you.

The workpapers were prepared for the purpose of providing the principal support for our report on Southern United Fire Insurance Company's December 31, 2001, statutory financial statements and to aid in the conduct and supervision of our audit. The workpapers document the procedures performed, the information obtained and the pertinent conclusions reached in the engagement. The audit procedures that we performed were limited to those we considered necessary under auditing standards generally accepted in the United States of America to enable us to formulate and express an opinion on the financial statements taken as a whole. Accordingly, we make no representation as to the sufficiency or appropriateness, for your purposes, of either the information contained in our workpapers or our audit procedures. In addition, any notations, comments, and individual conclusions appearing on any of the workpapers do not stand alone, and should not be read as an opinion on any individual amounts, accounts, balances, or transactions.

Our audit of Southern United Fire Insurance Company's December 31, 2001, statutory financial statements was performed for the purpose stated above and has not been planned or conducted in contemplation of your regulatory examination or for the purpose of assessing Southern United Fire Insurance Company's compliance with laws and regulations. Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our audit and the workpapers prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the Alabama Department of Insurance for the purpose of monitoring and regulating the financial affairs of Southern United Fire Insurance Company. In addition, we have not audited any financial statements of Southern United Fire Insurance Company since December 31, 2001, nor have we performed any audit procedures since February 5, 2002, the date of our auditor's report, and significant events or circumstances may have occurred since that date.

The workpapers constitute and reflect work performed or information obtained by KPMG in its capacity as independent auditor for Southern United Fire Insurance Company. The documents contain trade secrets and confidential commercial and financial information of our firm and Southern United Fire Insurance Company that is privileged and confidential, and we expressly reserve all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations when requests are made for the workpapers or information contained therein or any documents created by the Alabama Department of Insurance containing information derived therefrom. We further request that written notice be given to our firm before distribution of the information in the workpapers (or photocopies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.



Mr. Jack Brown
Alabama Department of Insurance
October 2, 2002
Page 3

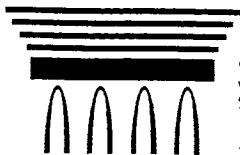
Any photocopies of our workpapers we agree to provide you will be identified as "Confidential Treatment Requested by KPMG LLP", (505 North 20th Street, Suite 1200 Birmingham, Alabama 35203).

Very truly yours,

KPMG LLP

A handwritten signature in cursive script that reads "Steve Richards".

Steven H. Richards
Partner



**SOUTHERN
UNITED**
ESTABLISHED 1963

www.southernunited.com

One Southern Way
Post Office Box 190429
Mobile, Alabama 36619

August 29, 2003

Mrs. Anne L. Ward, AFE
Examiner-In-Charge
Alabama Department of Insurance
201 Monroe Street, Suite 1840
PO Box 303351
Montgomery, AL 36130-3551

We are providing this letter in connection with your examination of the statutory financial statement of **Southern United Fire Insurance Company** as of June 30, 2002, and for the period from July 1, 2002 to August 29, 2003. We are responsible for the preparation of the statutory financial statements of financial position, results of operations, and changes in statutory financial position in conformity with the accounting practices prescribed or permitted by the Alabama Department of Insurance.

Certain representations in this letter are described as being limited to those matters that are material. Solely for the purpose of preparing this letter, the term "material," when used in this letter, means any item or group of similar items involving potential amounts of more than \$25,000. These amounts are not intended to represent the materiality threshold for financial reporting and disclosure purposes. Notwithstanding this, an item is considered material, regardless of size, if it involves an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during the examination.

1. We have made available to you all:
 - Statutory financial records and related data; and
 - Minutes of meetings of stockholders, directors and committees, or summaries of actions of recent meetings for which minutes have not yet been prepared.
2. There have been no:
 - Fraud or other irregularities involving management or employees who have significant roles in the internal control structure;

Customer Service (800) 851-9476 – (800) 677-7834

Claims Fax (800) 477-7834 • Underwriting Fax (251) 662-6563 • Marketing Fax (251) 662-6562 • Human Resources Fax (251) 662-6533

- Fraud or other irregularities involving other employees who have a material effect on the statutory financial statements;
 - Fraud or other irregularities involving agents, MGA's, third party administrators, independent contractors, holding companies or other individuals or parties that have or may have a material impact on the statutory financial position of the Company; or
 - Communications from regulatory agencies concerning noncompliance with, or deficiencies in, statutory financial reporting practices.
3. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
 4. The financial statements are free of material and intentional immaterial misstatements.
 5. The following have been properly recorded or disclosed in the statutory financial statements:
 - Any related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.
 - All liabilities, both actual and contingent.
 - Guarantees whether written or oral, under which the Company is contingently liable.
 - Capital Stock repurchase options or agreements on capital stock reserved for options, warrants, conversions, or other requirements.
 - Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.
 - Significant estimates and material concentrations known to management that are required to be disclosed in accordance with *SSAP No. 1, Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.
 - Amount of credit risk and extent, nature, and terms of financial instruments with off-balance-sheet risk in accordance with *SSAP No. 27*.
 - Agreements to repurchase assets previously sold.
 6. We confirm the completeness of the information provided regarding the identification of related parties.
 7. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the statutory financial statements or as a basis for recording a loss contingency.
 8. Contingent Liabilities:
 - There are no other liabilities or gain or loss contingencies that are required to be accrued or disclosed by *SSAP No. 5*.

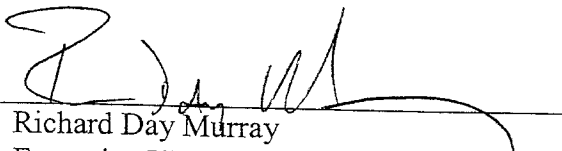
- There is no litigation against the Company that is considered material in relation to the statutory financial position of the Company. For purposes of this section, the Company has excluded litigation for which the only amounts sought relate to benefits within the normal terms of coverage under contracts of insurance issued by the Company, and which are otherwise considered in the actuarial determination of the Company's unpaid claim reserves.
 - *In the occurrence of a contingent liability noted by management the following should be included in the management representation letter:* there are no contingent liabilities which require disclosure in the financial statements or notes thereto.
9. Adequate provision has been made for adjustments and losses in collection of receivables.
 10. Provision has been made for estimated retroactive adjustments by third-party payors under reimbursement agreements.
 11. The Company is in compliance with bond indentures or other debt instruments.
 12. Pending changes in the organizational structure, financing arrangements, or other matters that could have a material effect on the financial statements of the Company are properly disclosed.
 13. The Company has properly classified all assets as admitted or nonadmitted in accordance with *SSAP No. 4*.
 14. The Company has free and clear title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged except as disclosed in the annual statement.
 15. We have reviewed long-lived assets and certain identifiable intangibles whenever changes in circumstances have indicated that the carrying amount of these assets might not be recoverable and have recorded the adjustment in accordance with *SSAP No. 5*.
 16. Deferred tax assets and liabilities as reported in the financial statements comply and have been valued in accordance with *SSAP No. 10, Income Taxes*.
 17. The Company has properly disclosed and recorded any premium deficiency reserves in accordance with *SSAP No. 53*.
 18. Investments are appropriately recorded and valued as follows:
 - Bonds – are recorded and disclosed in accordance with *SSAP No. 26*, and interpretations thereof.
 - Common stocks – are recorded and disclosed in accordance with *SSAP No. 30*, and interpretations thereof. Common stock of subsidiaries and affiliated or controlled companies are recorded and disclosed in accordance with *SSAP No. 46*, and interpretations thereof.
 - Short-term investments – are recorded and disclosed in accordance with *SSAP No. 2* and interpretations thereof.

- Real estate – is recorded and disclosed in accordance with *SSAP No. 40*, and interpretations thereof.
19. The Company's liabilities for unpaid losses and loss adjustment expenses are based on and recorded at management's best estimate in accordance with *SSAP No. 55*.
 20. Agents' balances or uncollected premiums have been recorded and disclosed in accordance with *SSAP No. 6*.
 21. There were no material commitments for construction or acquisition of property, plant and equipment, or to acquire other noncurrent assets, such as investments or intangibles.
 22. *In the event of a material commitment, replace clause #21 with the following:* there are no material commitments for construction, or acquisition of property, plant and equipment, or to acquire other noncurrent assets such as investments or intangibles which require disclosure in the financial statements.
 23. We have complied with all aspects of contractual agreements that would have a material effect on the statutory financial statement in the event of noncompliance.
 24. There are no material transactions that have not been properly recorded in the accounting records underlying the statutory financial statements.
 25. All required returns and statutory reporting requirements have been filed on a timely basis with the appropriate regulatory bodies.
 26. All material reinsurance transactions have been properly recorded and disclosed in accordance with *SSAP No. 62*.
 27. The Company has properly disclosed and recorded all changes in accounting principles in accordance with *SSAP No. 3*.
 28. The Company has recorded and disclosed subsequent events in accordance with *SSAP No. 9*.
 29. *In the event of a subsequent event, the following should replace clause #28 in the Management Representations Letter:* there have been no other events subsequent to period end which require adjustment of or disclosure in the financial statements or notes thereto.
 30. The Company is not aware of the employment of or a business relationship with a "prohibited person" as defined in The Violent Crime Control and Law Enforcement Act of 1994: United States Code, Section 1033 (e)(1)(A).
 31. The financial statements disclose all of the matters of which we are aware that are relevant to the Company's ability to continue as a going concern, including significant conditions and events, and management's plans.
 32. We agree with the findings of specialists in evaluating the loss and loss adjustment expense reserves and have adequately considered the qualifications of specialists in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to values or amounts derived in an attempt to bias their work.

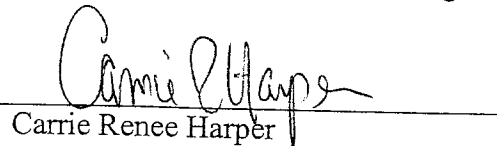
33. All valuations of securities were available from the NAIC Securities Valuation Office; therefore, the Company has determined a value for this financial instrument. The methods and significant assumptions used to determine this value are in accordance with *SSAP No. 27*.
34. The Company has recorded and disclosed defined benefit plans and defined contribution plans in accordance with *SSAP No. 8*.
35. The Company has recorded and disclosed postretirement benefits other than pensions in accordance with *SSAP No. 14*.

We understand that your examination was made in accordance with standards established by the Alabama Department of Insurance, and procedures established by *the National Association of Insurance Commissioners*, and accordingly included such tests of the accounting records and such other auditing procedures as were considered necessary under the circumstances.

SOUTHERN UNITED FIRE INSURANCE COMPANY


Richard Day Murray
Executive VP and Chief Operating Officer

8/29/03
Date


Carrie Renee Harper
Treasurer and Chief Financial Officer

8/29/03
Date



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
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MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 269-3550
FACSIMILE: (334) 241-4192
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COMMISSIONER
DEPUTY COMMISSIONER
D. DAVID PARSONS
JAMES R. (JOHNNY) JOHNSON
CHIEF EXAMINER
RICHARD L. FORD
STATE FIRE MARSHAL
JOHN S. ROBISON
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
PRODUCER LICENSING MANAGER
JIMMY W. GUNN

September 5, 2003

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. Richard Murray
Vice President & Chief Operating Officer
Southern United Fire Insurance Company
One Southern Way
Mobile, AL 36619

**RE: Southern United Fire Insurance Company
Report of Examination as of June 30, 2002**

Dear Mr. Murray:

Enclosed is a copy of the Report of Examination of the above-cited company as of June 30, 2002. In the event that you have any objections to this report, please advise this Department in writing within twenty (20) days, and a hearing will be scheduled, at which time you may present your arguments regarding any objections.

Unless we hear from you within the above-stated time, the report will be filed as a public document. Once filed, no annual or quarterly statements, or other material reflecting the statutory financial condition of the company may be filed with or accepted by this Department if those statements conflict with any basis of calculation to establish the value of any asset, liability, or capital account in the report.

Sincerely,

Richard L. Ford, CFE, CIE
Chief Examiner

RLF:dk

Enclosure

cc: Jack M. Brown, CFE, CIE
Anne L. Ward, AFE
Ken Smithson
Merlinos & Associates, Inc.
Insurance Logic, Inc.

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- Attach this card to the back of the mailpiece, or on the front if space permits.

1. Article Addressed to:

Mr. Richard Murray
Vice President & Chief Operating Officer
Southern United Fire Insurance Company
One Southern Way
Mobile AL 36619

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JOHN HERBERT ROTH

OF COUNSEL:
ROBERT S. RICHARD
JOHN B. SCOTT, JR.

September 26, 2003

John Davis, Esq.
Assistant Attorney General
Alabama Department of Insurance
201 Monroe Street, Ste. 1700
Montgomery, AL 36104

Re: Southern United Fire Insurance Company
Examination Report (Objections)
Our File No.: 24418-003

Dear Mr. Davis:

Confirming our telephone conversation earlier this afternoon, this is to advise that I have been retained to serve as local counsel, along with the law firm of Edwards & Angell of New York City, in matters relating to the most recent Examination Report of the ADOI relating to Southern United Fire Insurance Company.

We will be filing a formal response and objections on behalf of the company within the next few days, but, as we discussed by phone, the company strenuously objects to several of the specific findings within the Examination Report and sincerely believes that the Report should be modified, by either deleting these certain objectionable findings, or perhaps in some instances by modifying them.

Although I understand that the company's objections will necessitate the setting of this matter for a public hearing, I am also in hopes that we will be able, through informal discussions and the furnishing of supplemental information, where appropriate, to resolve all of the disputed issues without the necessity of a public hearing. I am sure you understand that the operations of this company have significantly improved since it was purchased by the Kingsway Group. Mr. Star and Kingsway Group, including Mr. Murray, the new President of Southern United, are serious in their intentions and desires to operate this company in strict compliance with all laws, regulations and requirements of the State of Alabama and the ADOI. You may be assured that you will receive the cooperation and conscientious effort of Southern United in continuing to

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334 241 8000 tel 334 323 8888 fax www.chlaw.com

make improvements and correcting any deficiencies that may exist. Thank you in advance for your consideration and cooperation.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Ken Wallis".

Kenneth D. Wallis, II

KDW:bb

cc: Richard Murray
Louis Fickett, Esq.
Nick Pearson, Esq.

Writer's Direct Number: (334) 241-8081
E-mail: kdw@chlaw.com

Edwards & Angell LLP

750 Lexington Avenue New York, NY 10022 212.308.4411 fax 212.308.4844
www.EdwardsAngell.com

Date : September 29, 2003

From : Lewis Fickett Fax : (888) 325-9140 Direct : (212) 756-0202

To : Richard L. Ford, CFE, CIE Fax : (334) 240-3194 Direct : (334) 260-3550

Pages : 8

(including cover sheet)

If you received a partial delivery, please call Lewis Fickett at (212) 756-0202.

Re : Southern United Fire Insurance Company

Fax

Confidentiality Note : The documents accompanying this facsimile contain information from the law firm of Edwards & Angell, LLP, which may be confidential and/or privileged. The information is intended for the use of the individual or entity named on this transmission sheet. If you are not the intended recipient, you are hereby notified that any disclosure, copying, distribution or the taking of any action in reliance on the contents of this facsimile is strictly prohibited, and that the documents should be returned to this firm immediately. If you have received this facsimile in error, please notify us by telephone immediately so that we can arrange for the return of the original documents to us at no cost to you.

Edwards & Angell

Nick Pearson
212.756.0275
fax 212.308.4844
npearson@EdwardsAngell.com

September 29, 2003

VIA FEDEX AND FACSIMILE (334) 240-3194

Mr. Richard L. Ford, CFE, CIE
Chief Examiner
State of Alabama Department of Insurance
201 Monroe Street, Ste. 1700
Montgomery, AL 36104

Re: Southern United Fire Insurance Company ("SUFI")

Dear Mr. Ford:

Further to Ken Wallis' earlier letter on behalf of SUFI, we are writing on behalf of SUFI in response to the Alabama Department of Insurance's (the "Department") draft report of examination (the "Draft Report") as of June 30, 2002. This letter, in addition to being a formal written objection to the Draft Report, is also a request for a hearing with the Department regarding the Draft Report. Below, we set forth SUFI's initial responses and objections to the Draft Report under the corresponding sections of the Draft Report.

SUFI will be supplementing these responses prior to the holding of a formal hearing (the "Prehearing Statement"). Based on the discussion between John Davis, Esq., of the Department's Legal Division, and my colleague, Lewis Fickett, on Wednesday, September 24, we understand that the Department requests that we submit the Prehearing Statement twenty (20) business days prior to the date of the hearing.

I. HOLDING COMPANY AND AFFILIATE MATTERS.

1. Transactions and Agreements with Affiliates.

Draft Report Pages: 10 – 12

SUFI objects to the Draft Report with respect to the discussion of the Management Services and Facilities Agreement (the "Management Agreement") and any regulatory sanctions related thereto.

The Management Agreement has defined the relationship between SUFI and Consolidated Insurance Management Corporation ("CIMC") at least as far back as the early

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September 29, 2003

Page 2

1990's. A November 17, 1999 Form D filing (the "1999 Form D") indicated that SUFI and CIMC have been operating under a Management Service and Facilities Agreement since 1989.

The Department contends that SUFI has not been able to produce documentation indicating that the Department has approved the Management Agreement. Section 27-29-5(b) of the Alabama Insurance Code provides, however, that a Form D filing is deemed approved after 30 days unless the Department objects to it. The Department has not produced any documentation prior to May 23, 2002 by which it disapproved the Management Agreement. Furthermore, the Department clearly cannot contend that SUFI never filed the Management Agreement.

In the report of examination as of March 31, 2001 (the "2001 Report"), the Department acknowledged the existence of the Management Agreement and listed the terms of payment under the Management Agreement as a sliding scale based upon written premiums and the percentages. In the 2001 Report, the Department also acknowledged that the Management Agreement was revised on November 17, 1999 and cites the 1999 Form D as being made in accordance with the Alabama statutes.

Furthermore, the Department's reports of examination as of June 30, 1994, December 31, 1995 and December 31, 1997 also acknowledge the existence of the Management Agreement and cite wording similar to the wording of the current Management Agreement. Each of these earlier examination reports also acknowledges a sliding scale of commissions based upon premiums, the issue which the Department has cited as being problematic in the Draft Report.

Therefore, the Department's own reports prove that it was well aware of the existence and structure of the Management Agreement and that SUFI had filed the Management Agreement with the Department. The Department cannot now retroactively penalize SUFI for conduct of which the Department's own reports indicate it had been aware for at least nine years and to which it consented under the provisions of the Alabama Insurance Code.

Further, SUFI objects in the most strenuous terms to the inclusion of references to potential penal sums since such a determination is beyond the scope and objective of the Draft Report. Nowhere else in the Draft Report is there any estimation of potential fines or penalties and the inclusion herein is wholly gratuitous, inflammatory and potentially injurious to SUFI's business reputation.

II. MARKET CONDUCT ACTIVITIES.

1. Treatment of Policyholders and Claimants.

Edwards & Angell LLP

September 29, 2003

Page 3

i. Complaint Handling.

Draft Report Pages: 18 – 20

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Complaint Handling."

ii. Policyholder Service.

Draft Report Pages: 20 – 21

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Policyholder Service."

SUFI's objections include, but are not limited to, the Department's contention that SUFI has never required its premium finance companies to furnish lien holders' with copies of the cancellation notices. The only premium financing allowed by SUFI in Alabama is through Time Payment Plan, Inc. ("TPP"). TPP is the premium finance company owned by Southern United Holding Inc., SUFI's intermediate parent. TPP sends notices of intent to cancel and cancellation notices to SUFI, but it does not mail any of these notices to SUFI since the notices are generated on SUFI's premises.

2. Marketing and Sales.

Draft Report Pages: 21 – 23

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Marketing and Sales."

SUFI's objections include, but are not limited to, the Department's contention that its website does not comply with the NAIC's Market Conduct Handbook.

3. Compliance with Agents' Licensing Requirements.

i. Producer Licensing.

Draft Report Pages: 23 – 24

Edwards & Angell LLP

September 29, 2003

Page 4

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Producer Licensing."

SUFI's objections include, but are not limited to, the Department's contentions that it did not maintain producer records properly, monitor agents properly or compensate agents appropriately.

ii. Producer Terminations.

Draft Report Pages: 24 – 25

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Producer Terminations."

SUFI's objections include, but are not limited to, the Department's contentions that it did not maintain appropriate termination records, producer information, or agent-monitoring systems.

4. Underwriting and Rating.

i. Active Policies.

Draft Report Pages: 25 – 28

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Active Policies."

SUFI's objections include, but are not limited to, the Department's contentions that its charged rates were not in accord with its filed rates or rating plan and that its file documentation was not sufficient to support claims decisions.

ii. Cancelled/terminated Policies.

Draft Report Pages: 28 – 31

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Cancelled/terminated Policies."

Edwards & Angell LLP

September 29, 2003
Page 5

SUFI's objections include, but are not limited to, the Department's contentions that its cancellation notices, reasons for cancellation and refund verification procedures were not in compliance with Alabama law.

5. Claims Payment Practices.

i. Paid Claims.

Draft Report Pages: 32 – 36

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Paid Claims."

SUFI's objections include, but are not limited to, the Department's contentions that claims' files did not include adequate documentation and that there were discrepancies between the actual handling of claims and policy provisions.

ii. Denied Claims.

Draft Report Pages: 36 – 38

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Denied Claims."

SUFI's objections include, but are not limited to, the Department's contentions that claims' file documentation is not sufficient to support decisions.

III. NOTES TO FINANCIAL STATEMENTS.

1. Note 8 Losses, Note 9 Loss Adjustment Expenses and Note 10 Commissions payable, contingent commissions, and similar charges.

Draft Report Pages: 59 – 63

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Note 8 Losses, Note 9 Loss Adjustment Expenses and Note 10 Commissions payable, contingent commissions, and similar charges."

Edwards & Angell LLP

September 29, 2003

Page 6

SUFI's objections include, but are not limited to, the Department's contentions that SUFI's reserves were deficient, liabilities were excessive and the provision of documentation to the Department was inadequate.

2. Note 12 - Advance premiums.

Draft Report Pages: 63 - 64

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Advance premiums."

IV. SUBSEQUENT EVENTS.

1. Risk-Based Capital (RBC).

Draft Report Pages: 83 - 84

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Risk-Based Capital."

SUFI's objections include, but are not limited to, the Department's contentions that its reserves were deficient and that its Risk-Based Capital level qualified as "Company Action Level."

2. Losses and Loss adjustment expenses.

Draft Report Pages: 84 - 85

SUFI objects to the Draft Report with respect to the criticisms contained in the section of the Draft Report entitled "Losses and Loss adjustment expenses."

SUFI's objections include, but are not limited to, the accuracy of the appointed actuary's estimates.

V. CONCLUSION.

Thank you for your attention and your consideration of these objections. We look forward to notification of the date on which SUFI's hearing will be scheduled. SUFI proposes a

Edwards & Angell

September 29, 2003

Page 7

meeting with the Department to determine whether some of its objections can be resolved prior to the hearing so that the hearing will take no more of the Department's and SUFI's energies than is necessary.

Best regards.

Sincerely yours,



Nick Pearson

cc: John J. Davis, Esq.
James R. Zuhlke
Richard Murray
Kenneth Wallis, Esq.

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P. 01

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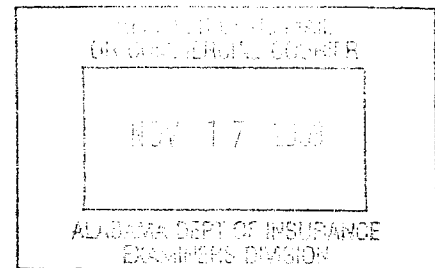
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Lewis Fickett III
212.756.0202
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lfickett@EdwardsAngell.com

November 14, 2003

VIA FEDEX

Mr. Richard L. Ford, CFE, CIE
Chief Examiner
State of Alabama Department of Insurance
201 Monroe Street, Ste. 1700
Montgomery, AL 36104



Re: Southern United Fire Insurance Company ("SUFI")

Dear Mr. Ford:

Further to my colleague Nick Pearson's letter of September 29 (the "Formal Objection"), we are writing on behalf of SUFI in response to the Alabama Department of Insurance's (the "Department") draft report of examination (the "Draft Report") as of June 30, 2002. This letter shall not constitute our "Prehearing Statement" referenced in the Formal Objection but is submitted to you in preparation for the informal meeting (the "Meeting") between department officials, representatives of SUFI and SUFI's counsel on Thursday, November 20, 2003 at the Department's offices, the intent of which is to resolve and settle disputed items in the Draft Report. At the Meeting, SUFI will be represented by Kenneth D. Wallis, Esq. of Capell & Howard, P.C. and the undersigned. Anything contained herein or discussed at the Meeting shall be without prejudice to SUFI's Prehearing Statement and testimony or other evidence adduced at the hearing, should one be required.

Attached as Exhibit A to this letter is a "computer marked" copy of the Draft Report. This copy of the Draft Report (the "Revised Report") has been edited in following manner. Language which we propose should be removed from the Draft Report prior to the issuance and filing of the final examination report (the "Final Report") has been "struck through" and language which we propose should be added to the Draft Report prior to the issuance and filing of the Final Report has been inserted in "double underlined" text.

Below, we set forth SUFI's explanations of the proposed changes to the Draft Report under the corresponding sections of the Draft Report.

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Page 7

departmental information such as, telephone numbers, fax numbers and e-mail addresses. SUFI's actual physical address is included on this page. Finally, SUFI's advertising materials always include toll-free telephone numbers and website information for easy access to SUFI.

Based on our review of the Review Procedures, the Department's interpretation thereof is too narrow. There is no specific statement in the Review Procedures that a company's lines of business, address and telephone number must appear on the actual website homepage rather than on a page to which the reader can gain instant access by clicking on a hyperlink. Since there is no specific authority requiring that this information needs to be included on the website homepage, the Department should not sanction SUFI with respect to this issue. SUFI has, however, revised its website homepage in order to make it comply with the Department's unpublished interpretation of the Review Procedures and, henceforth, its website homepage will include SUFI's relevant telephone numbers, physical address and e-mail addresses.

3. Underwriting and Rating – Cancelled/terminated Policies.

SUFI has edited the Revised Report in paragraph 5 of page 28, to correct the Department's statement about SUFI's cancellation policies. The Department asserted that SUFI treats cancellations within the first sixty (60) days of a policy as a "declination of coverage." This statement is not true. Consequently, SUFI has deleted this sentence from the Revised Report.

III. RISK – BASED CAPITAL.

SUFI has edited the Revised Report to propose changes regarding the discussion of SUFI's actuarial loss and loss adjustment expense reserves as of December 31, 2002. The Draft Report stated that the reserves for losses, loss adjustment expenses and commissions payable, contingent commissions, and other similar charges, were improved but still deficient at that date.

SUFI uses KPMG as an independent actuarial firm to evaluate their reserve adequacy at year-end. KPMG works with SUFI to establish an accurate range for total loss and loss adjustment expense reserves and defense cost containment expenses by using sound actuarial methodologies and understanding the changes made within SUFI that would affect their opinion. SUFI relies upon KPMG's opinion to establish its year-end financials. A copy of KPMG's opinion (the "KPMG Opinion") is attached hereto as Exhibit F.

SUFI has received the Department's assigned actuary's (the "Assigned Actuary") opinion and their work papers (the "Work Papers") from officials of the Department. SUFI did not see

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Page 8

any reference in the Work Papers to the use of the Berquist-Sherman methodology by the Assigned Actuary. SUFI contacted Mark Brannon, a representative of the Assigned Actuary, to point out the large average year-end case reserve increase and to ask if the Assigned Actuary considered the Berquist-Sherman methodology in performing its analysis. Mr. Brannon replied and indicated that the Assigned Actuary did consider all of KPMG's methodologies, including the Berquist-Sherman methodology. However, it appears due to the discrepancy in actual results that the Assigned Actuary apparently did not give sufficient weight to the Berquist-Sherman methodology in reaching its final conclusions.

The Assigned Actuary's failure to allocate sufficient weight to the Berquist-Sherman methodology is a serious flaw in its overall analysis. The Berquist-Sherman methodology is an industry standard methodology for the actuarial evaluation of companies which have seen a significant increase or decrease in average case reserves. Since SUFI had experienced a significant increase in average case reserves in the last quarter of 2002, the Berquist-Sherman methodology should have been given greater weight in the Assigned Actuary's analysis.

Having made the decision to significantly strengthen its case reserves in the 4th quarter of 2002, SUFI believes that the KPMG estimate reflects an adequate reserve position for SUFI at year-end 2002. As Mr. Brannon points out in an e-mail, as part of his justification of their selections, "Our reserve estimates are within KPMG's reasonable range on both a gross and net basis." Using KPMG's reserve estimates, SUFI would like to point out that its carried reserves at year-end 2002 were within KPMG's "...reasonable range on both a gross and a net basis."

An independent estimate by the Assigned Actuary determined that SUFI's loss and LAE reserves were deficient by \$1,012,000, and the contingent commissions liability was deficient by \$19,000. This adjustment would reduce SUFI's surplus as regards policyholders reported in SUFI's 2002 Annual Statement to \$12,752,814. Such a potential reduction in SUFI's surplus as regards policyholders would then elevate SUFI's risk based capital level (the "RBC Level") to 198%, or "Company Action Level."

The RBC Level of 198% is a direct result of the Assigned Actuary's assertion that SUFI's reserves were deficient by \$1,012,000. SUFI does not agree that its year-end 2002 reserve position was deficient because the Assigned Actuary failed to allocate sufficient weight to the Berquist-Sherman methodology in arriving at its reserve calculations. Consequently, SUFI does not agree that SUFI's RBC Level was 198%, or "Company Action Level" at year-end 2002. Specifically, SUFI has edited the Revised Report in the following places:

Page #

Paragraph #

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Page 9

44	1
83	3
83	6

IV. CONCLUSION.

For the reasons set forth above, SUFI objects to the foregoing contents of the Draft Report. We request that the Draft Report be edited as provided in the Revised Report prior to the filing of the Final Report. We look forward to discussing these issues at the Meeting on November 20, 2003.

Best regards.

Sincerely yours,



Lewis Fickett III

cc: John J. Davis, Esq.
Richard Murray
Kenneth Wallis, Esq.
Nick Pearson, Esq.

FOR SETTLEMENT PURPOSES ONLY
WITHOUT PREJUDICE COMMUNICATION

Exhibit A

Revised Report



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
POST OFFICE BOX 303351
MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 269-3550
FACSIMILE: (334) 241-4192
INTERNET: www.aldoi.gov

January 26, 2004

WALTER A. BELL
COMMISSIONER
ASSISTANT COMMISSIONER
RAGAN INGRAM
DEPUTY COMMISSIONERS
D. DAVID PARSONS
JAMES R. (JOHNNY) JOHNSON
CHIEF EXAMINER
RICHARD L. FORD
STATE FIRE MARSHAL (ACTING)
RICHARD MONTGOMERY
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Mr. Richard Murray
Vice President & Chief Operating Officer
Southern United Fire Insurance Company
One Southern Way
Mobile, AL 36619

RE: Southern United Fire Insurance Company
Report of Examination as of June 30, 2002

Dear Mr. Murray:

Enclosed is a copy of the revised Report of Examination of the above-cited company as of June 30, 2002. In the event that you have any objections to this report, please advise this Department in writing within twenty (20) days, and a hearing will be scheduled, at which time you may present your arguments regarding any objections.

Unless we hear from you within the above-stated time, the report will be filed as a public document. Once filed, no annual or quarterly statements, or other material reflecting the statutory financial condition of the company may be filed with or accepted by this Department if those statements conflict with any basis of calculation to establish the value of any asset, liability, or capital account in the report.

Sincerely,

Richard L. Ford, CFE, CIE
Chief Examiner

RLF:dk

Enclosure

cc: Jack M. Brown, CFE, CIE
Anne L. Ward, AFE
Ken Smithson
Merlinos & Associates, Inc.
Insurance Logic, Inc.

SENDER: COMPLETE THIS SECTION

- Complete items 1, 2, and 3. Also complete item 4 if Restricted Delivery is desired.
- Print your name and address on the reverse so that we can return the card to you.
- Attach this card to the back of the mailpiece, or on the front if space permits.

1. Article Addressed to:

Mr. Richard Murray
Vice President & Chief Operating Officer
Southern United Fire Insurance Company
One Southern Way
Mobile, AL 36619

2. Article Number (Copy from service label)

7002 2030 0000 9484 1468

PS Form 3811, July 1999

Domestic Return Receipt

102595-00-M-0952

COMPLETE THIS SECTION ON DELIVERY

A. Received by (Please Print Clearly)

TRAY WATKINS

B. Date of Delivery

2/4/94

C. Signature

X *Tray Watkins*

☐ Agent☐ Addressee

D. Is delivery address different from item 1?

☐ Yes

If YES, enter delivery address below:

☐ No

3. Service Type

☒ Certified Mail☐ Express Mail☐ Registered☒ Return Receipt for Merchandise☐ Insured Mail☐ C.O.D.

4. Restricted Delivery? (Extra Fee)

☐ Yes**SENDER: COMPLETE THIS SECTION**

- Complete items 1, 2, and 3. Also complete item 4 if Restricted Delivery is desired.
- Print your name and address on the reverse so that we can return the card to you.
- Attach this card to the back of the mailpiece, or on the front if space permits.

1. Article Addressed to:

Mr. Matthew P. Merlino
Merlinos & Associates, Inc.
3274-B Medlock Bridge Road
Norcross, GA 30092

2. Article Number (Copy from service label)

7002 2030 0000 9484 1475

PS Form 3811, July 1999

Domestic Return Receipt

102595-00-M-0952

COMPLETE THIS SECTION ON DELIVERY

A. Received by (Please Print Clearly)

B. Date of Delivery

C. Signature

X *Deb Hamilton*

☐ Agent☐ Addressee

D. Is delivery address different from item 1?

☐ Yes

If YES, enter delivery address below:

☐ No

3. Service Type

☒ Certified Mail☐ Express Mail☐ Registered☒ Return Receipt for Merchandise☐ Insured Mail☐ C.O.D.

4. Restricted Delivery? (Extra Fee)

☐ Yes

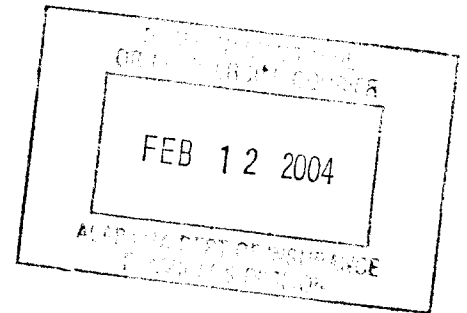
FOR SETTLEMENT PURPOSES ONLY
WITHOUT PREJUDICE COMMUNICATION

Lewis Fickett III
212.756.0202
fax 888.325.9140
lfickett@EdwardsAngell.com

February 11, 2004

VIA FEDEX

Mr. Richard L. Ford, CFE, CIE
Chief Examiner
State of Alabama Department of Insurance
201 Monroe Street, Ste. 1700
Montgomery, AL 36104



Re: Southern United Fire Insurance Company ("SUFI")

Dear Mr. Ford:

We are writing on behalf of SUFI in response to the Alabama Department of Insurance's (the "Department") draft Report of Association Examination (the "Second Draft Report") as of June 30, 2002 sent to Richard Murray under cover of your letter dated January 26, 2004. This letter is the formal written objection to the Second Draft Report and a request for a hearing with the Department regarding the Second Draft Report. Below, we set forth SUFI's responses and objections to the Second Draft Report under the corresponding sections of the Second Draft Report. We reserve the right to submit additional written materials (the "Meeting Submissions") prior to any hearing or meeting regarding these issues. Anything contained herein shall be without prejudice to the Meeting Submissions and testimony or other evidence adduced at a meeting or hearing, should one be required.

We attach as Exhibit A the cover page of the Second Draft Report and copies of pages 8, 9, 10, 59, 60 and 71 computer marked to show our proposed changes. You will note that these page numbers do not precisely correspond to the page numbers in the copy of the Second Draft Report sent to us because of repagination in the process of scanning the document. The corresponding pages in the original copy of the Second Draft Report are 10, 12, 13, 71 and 84, but all subsequent page references in this letter shall be for pages attached as Exhibit A. Language we propose removing from the Second Draft Report prior to the issuance and filing of the final examination report (the "Final Report") has been struck through and language we propose adding to the Second Draft Report prior to the issuance and filing of the Final Report has been inserted in double underlined text.

February 11, 2004
Page 2

I. **HOLDING COMPANY AND AFFILIATE MATTERS.**

We propose editing pages 8, 9, 10, 59 and 60 to more accurately describe the status of the Management Services & Facilities Agreement (the "Management Agreement") between SUFI and its affiliate, Consolidated Insurance Management Corporation ("Consolidated").

We propose revising the second paragraph on page 8 and the fourth paragraph on page 10 to reflect undisputed facts regarding the Management Agreement. The Department acknowledged on page 10 of its Report of Limited Scope Examination as of March 31, 2001 (the "2001 Report"), which page along with the cover page of the 2001 Report we attach as Exhibit B, that SUFI filed the Management Agreement for approval. Furthermore, the Department discussed the terms of the Management Agreement without objection in the 2001 Report as well as in the three previous reports of examination dated as of December 31, 1997, December 31, 1995 and June 30, 1994, copies of which were submitted to the Department with our letter of November 14, 2003. We strongly believe that the Final Report must reflect the Department's previous statement that SUFI filed the Management Agreement for approval and that the Department reviewed the Management Agreement without objection in the four previous examination reports for this to be a fair and balanced report.

We propose editing the fifth paragraph on page 9 to correct an error. Item 10.B. of SUFI's 2001 Annual Statement notes to financial statements characterized Consolidated as a "managing agent" rather than as a "managing general agent" as the Second Draft Report indicates. We also propose revising the first paragraph on page 10 to correct a typographical mistake.

As have we previously noted, the inclusion or characterization of hypothetical fine amounts in the Second Draft Report does not serve a valid regulatory goal and may adversely affect SUFI's dealings with insurance regulators in other states and SUFI's affiliates' relations with investors and ability to raise capital. Certainly, the Department cannot be seeking to inflict any of these injuries by issuing the Final Report.

Consequently, we propose editing paragraphs 2 and 4 on page 10 to eliminate any characterization of the amount of any potential fines faced by SUFI in conjunction with the Management Agreement. We also propose removing language in the last paragraph on page 59 which carries over to page 60 and the first full paragraph on page 60 to make that section consistent with the "*Transactions and Agreements with Affiliates*" section of the Second Draft Report which does not present dollar amounts of premium written or commissions paid from which a fine could be calculated. These changes are particularly necessary since the Department has indicated that, if this matter can be resolved without future administrative proceedings, it is

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Page 3

not inclined to pursue any administrative penalty against SUFI in conjunction with the Management Agreement.

II. RISK – BASED CAPITAL.

We propose adding a paragraph on page 71 of the discussion of “*Risk-Based Capital*” in “*SUBSEQUENT EVENTS*” section of the Second Draft Report to explain why SUFI’s reserves were viewed as deficient by the Department. SUFI relied on the reserve estimate range produced by its outside actuary, KPMG, in establishing its reserves. The Department’s actuary selected a specific dollar value for those reserve estimates. These reserve estimates differed only slightly. In the words of the Department’s actuary, “[O]ur reserves are within KPMG’s reasonable range on both a gross and a net basis.” SUFI’s reserves were also within KPMG’s reasonable range on both a gross and a net basis.

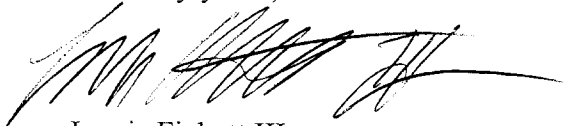
Consequently, the deviation in reserve estimates causing the Department to view SUFI’s reserves as being deficient resulted from a disagreement between two actuaries – KPMG hired by SUFI and Merlino & Associates hired by the Department. We strongly believe that the Final Report should reflect that SUFI’s classification at “Company Action Level” derived from this disagreement and the magnitude of this disagreement was relatively small for this to be a fair and balanced report.

III. CONCLUSION.

For the reasons set forth above, SUFI objects to the Second Draft Report and requests that it be edited as proposed in the pages attached as Exhibit A prior to the filing of the Final Report. If the changes set forth in Exhibit A are effected, SUFI will gladly withdraw its objection to the Second Draft Report and its request for a hearing.

Best regards.

Sincerely yours,



Lewis Fickett III

cc: John J. Davis, Esq.
Richard Murray
Kenneth Wallis, Esq.
Nick Pearson, Esq.

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WITHOUT PREJUDICE COMMUNICATION

Exhibit A

Pages Containing Proposed Edits to Second Draft Report

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

REPORT OF ASSOCIATION EXAMINATION
OF
SOUTHERN UNITED FIRE INSURANCE COMPANY
Mobile, Alabama

as of
June 30, 2002

Participation:
Alabama

Transactions and Agreements with Affiliates

Management Services and Facilities Agreement:

A *Management Services and Facilities Agreement* was entered into by and between the Company and Consolidated Insurance Management Corporation (CIMC). The Company and CIMC are affiliated companies in a group of wholly owned subsidiaries of Kingsway Financial Services Inc., a Canadian insurance and financial services holding company.

~~While~~Although Company records indicated that an initial contract was executed in 1989, ALDOI files did not contain ~~reiterate that this or any other management arrangement between the referenced companies prior to April 2002, although ALDOI files did contain a cover letter from the Company with the 1999 revision of the management agreement and the ALDOI acknowledged in its Report of Limited Scope Examination as of March 31, 2001 that the "... agreement was filed for approval..." had been received by the ALDOI. While The ALDOI examiners did review copies of the management agreement during the course of the prior four examinations, covering the period from December 31, 1990 to March 31, 2001, and no objections were raised to previous examination reports the terms of~~discussed the existence of a management agreement, no evidence could be located that substantiated its submission to or approval/disapproval by the Commissioner. Concerning transactions between an insurer and any person in its holding company system, ALA. CODE § 27-29-5 (b) (1975), states, in pertinent part, that an agreement

... may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto
... and the commissioner has not disapproved it within that period."

The Company asserts that a revised agreement was filed with the ALDOI on November 17, 1999, "to reflect current cost and service levels within the organization." Evidently, this version was utilized during the examination period; however, the provisions do not comply with the requirements of the *Alabama Insurance Code*. The term of this agreement was three years commencing on January 1, 2000, and terminating on December 31, 2002. The agreement would automatically renew for each subsequent three year period unless written notice was provided by either party sixty days prior to expiration.

The above parties hereto agreed as follows:

- The Company agreed to reimburse CIMC for commission expenses paid to producing agents. In addition, the Company will pay CIMC a percentage of each calendar month's gross direct and assumed written premium, net of cancellations, a sliding servicing fee based on the following written premiums:

MONTHLY GROSS WRITTEN PREMIUM NET OF CANCELLATION	SERVICING FEES
\$0.00 up to \$4,000,000.00	21.0%
\$4,000,000.01 up to \$8,000,000.00	18.0%
\$8,000,000.01 and over	16.0%

- CIMC agreed to provide the Company at no additional cost the following additional services reasonably related thereto:
 - a. accounting and financial services
 - b. electronic data processing services
 - c. sales and marketing services including the payment to agents of all commissions due agents
 - d. employment of personnel necessary to properly enable the insurance Company to function
 - e. claims management and adjustment services
 - f. telephone services
 - g. postage.
- CIMC agreed to provide the Company at no additional cost the following facilities and any additional facilities reasonably related thereto:
 - a. office space
 - b. books, periodicals and subscriptions to trade publications
 - c. office furniture and equipment
 - d. casualty insurance coverage
 - e. general purpose supplies and printed materials (including supplies and printed materials specially related to Company's business, such as policy and claims forms).

On April 22, 2002, in response to recommendations made in the *Report of Limited Scope Examination* as of March 31, 2001, and in accordance with ALA. CODE § 27-29-5 (1975), and ALDOI Regulation No. 55, the Company filed a *Form D – Prior Notice of a Transaction*, concerning “Addendum 1 to the Management Services and Facilities Agreement.” On May 23, 2002, based on representations made in that Form D filing, this amendment was disapproved based upon the method of calculating the fees. The ALDOI permits reimbursement based upon actual cost plus any overhead to provide services, not on a percentage of premiums received. Apparently, the agreement has been amended several times, resubmitted to the ALDOI and rejected each time for various reasons.

It was noted that under the agreement utilized, the Company paid CIMC for management, services and expenses, which included commissions, during the five-year examination period. Because the *Management Services and Facilities Agreement* did not comply with the provisions of the relevant sections of the *Alabama Insurance Code*, payment of management fees, etc., was not appropriate.

Item # 10.B., of the Company's 2001 Annual Statement *Notes to Financial Statements* indicated that commissions were paid to CIMC as managing general agent (MGAMA). ALA. CODE § 27-6A-2(3)c.3 (1975) stipulates, in pertinent part, that.

“An underwriting manager, who, pursuant to contract, manages all or part of the insurance operations of the insurer, is under the common control with the insurer., subject to the Alabama Insurance Holding Company System Regulatory Act, chapter 29, commencing with section 27-29-1, of this title, and **whose**

compensation is not based on the volume of premiums written.” [emphasis added]

Management indicated that “CIMC does not have an MGA license in effect as of June 30, 2002,” and “no MGA contract is in force between SUFI and CIMC.” The Company has been “operating under the belief that the relationship of CIMC and SUFI falls under the Holding Company Statutes and CIMC has been considered an underwriting manager under the definition of an MGA (27-6A-2c3).” This examination has determined that the Company has been acting in the capacity ~~as of~~ an MGA as defined by ALA. CODE § 27-6A-2 (1975) and does not meet the requirements for exemption as the compensation schedule, as discussed previously in this section, was based on the volume of premiums written (commission).

ALA. CODE § 27-6A-4 (1975) requires a written MGA contract between the Company and CIMC. In addition, CIMC was not licensed as an MGA as required by ALA. CODE § 27-6A-3 (1975), nor as any other person as defined in ALA. CODE § 27-7-1 (1975). CIMC was not appointed as a producer in accordance with ALA. CODE § 27-7-4(b) (1975). ~~The Company reported substantial earned premiums produced by CIMC during the five-year examination period.~~ Consequently, the Company would be contingently liable for a fine of up to three times the premium received from CIMC, in accordance with Section 27-7-4(a) of the *Alabama Insurance code*.

It should also be noted that ALA. CODE § 27-7-4.1 (a) (1975) states, in pertinent part, that:

“No insurer or producer shall pay, directly or indirectly, any commission or other valuable consideration to any person for services as a producer or service representative within this state unless the person holds a current valid license as a producer or service representative...”

Item (b) of that statute stipulates that an insurer or producer violating said section “shall be liable for a fine in an amount of up to three times the amount of the commission paid.” Documentation evidencing commissions paid to CIMC was provided by the Company in the *GL Transaction Report* as of June 30, 2002, accordingly, the Company ~~would~~ be contingently liable for a fine of as much as three times the commission paid. However, in mitigation, the ALDOI did not raise any of these objections in the course of the four prior examinations.

The Company and the ALDOI have been working together in order to insure that the agreement is in accordance with ALA. CODE § 27-29-5 (1975). In order to avoid administrative and financial penalties provided for in ALA. CODE § 27-7-4.1 (a) and (b) (1975), the Company submitted a revised agreement to the ALDOI, which, in the opinion of the ALDOI’s Legal Division, appears to comply with the *Alabama Insurance Code*. The agreement is currently under review by the Commissioner and subject to his approval. At the date of this report, however, the Company had not, obtained final approval of its management agreement.

Subsequent to the examination date, Company management indicated that the affiliated CIMC would be dissolved; consequently, SUFI intends to manage its own business and services. Should this come into fruition, the need for a management agreement would thereby be eliminated.

Unassigned funds (surplus) per Company	<u>\$(14,082,057)</u>
---	------------------------------

Examination increase/(decrease) to assets:

• Cash and short-term investments (Note 3)	\$ (5,624,911)
• Premiums and agents' balances in course of collection (Note 4)	(92,305)
• Guaranty funds receivable and on deposit (Note 7)	(662,203)
Total increase/ (decrease) to assets	<u>\$ (6,379,419)</u>

Examination (increase/(decrease) to liabilities:

• Losses (Note 8)	\$ (1,852,000)
• Loss adjustment expenses (Note 9)	(744,981)
• Commissions payable, contingent commissions and other similar charges (Note 10)	(2,725,386)
• Advance premium (Note 12)	(169,345)
• Payable to parent, subsidiaries and affiliates (Note 15)	<u>(845,099)</u>
Total increase/ (decrease) to liabilities	<u>\$ (6,336,811)</u>

Net Increase (Decrease)	<u>(12,716,230)</u>
-------------------------	---------------------

Unassigned funds (surplus) per Examination	<u>\$(26,798,287)</u>
---	------------------------------

The \$12,716,230 decrease to *Unassigned funds* reduces *Surplus as regards policyholders* to \$(1,610,837), rendering the Company insolvent at the examination date.

CONTINGENT LIABILITIES AND PENDING LITIGATION

The review of contingent liabilities and pending litigation included an inspection of representations made by management, a review of a report to the independent CPAs on pending litigation made by Company counsel, and a general review of the Company's records and files conducted during the examination, including a review of claims. This review did not disclose items that would have a material affect on the Company's financial position in the event of an adverse outcome.

It was noted that the Company did not reserve any funds for legal actions brought against the Company. No reserve had been established for expenses of litigation on lawsuits known to exist at the June 30, 2002 reporting date. Further information concerning DCCE and AO reserving may be found in this report in the NOTES TO FINANCIAL STATEMENTS section under "Note 8 – Losses," and "Note 9 – Loss adjustment expenses."

As was noted previously under the *Transactions and Agreements with Affiliates* caption in HOLDING COMPANY AND AFFILIATE MATTERS, the Company's affiliate, CIMC, was not licensed as an MGA as required by ALA. CODE § 27-6A-3 (1975), nor as any other person as defined in ALA. CODE § 27-7-1 (1975). In addition, CIMC was not appointed as a producer in accordance with ALA. CODE § 27-7-4(b) (1975). The Company reported earned premiums

of \$35,125,978, for the first six months of 2002. Section 27-7-4(a) of the *Alabama Insurance Code*, in pertinent part, provides as follows:

“Any insurer accepting business directly from a person not licensed for that line of authority and not appointed by the insurer shall be liable to a fine of up to three times the premium received from that person.”

In addition, ALA. CODE § 27-7-4.1 (a) (1975) states that commission shall not be paid to any person unless that “person holds a current valid license as a producer or service representative.” Item (b) of that statute stipulates that an insurer or producer violating said section “shall be liable for a fine in an amount of up to three times the amount of the commission paid.” ~~Company documentation evidenced \$5,105,823 in paid commissions, as of the June 30, 2002 examination date.~~

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

A review was conducted during the current examination with regard to the Company’s compliance with recommendations made in the previous examination report. This review indicated that the Company had satisfactorily complied with the prior recommendations with the exception of certain items listed below:

Market Conduct Activities:

Treatment of Policyholders and Claimants – The previous examination report recommended the Company implement and maintain measures to ensure that all claims are promptly investigated, promptly paid, and claimants are promptly notified of denials in accordance with Section 27-12-24, Code of Alabama 1975, as amended. The Company did not comply with this recommendation in its entirety.

It was recommended that the Company implement procedures to ensure that checks issued for the settlement of claims be distributed to claimants in a timely manner, and further, that the Company monitor the checks issued and outstanding to ensure that checks are provided to claimants in a timely manner. The Company had not complied with this recommendation in its entirety.

It was recommended that the Company take measures to ensure that all estimates utilizing aftermarket crash parts include the disclosure required by Section 32-17A-3, Code of Alabama 1975, as amended. The Company had not complied with this recommendation.

It was recommended that the Company keep and maintain complete records to document claim payments in accordance with Section 27-27-29(a), Code of Alabama 1975, as amended. The Company had not complied with this recommendation.

It was recommended that the Company implement and maintain measures to ensure that all claims are promptly investigated, settled, and paid within reasonable time limits in accordance with Section 27-12-24, Code of Alabama 1975, as amended. While the Company stated that it has implemented service standards to ensure that all claims are promptly investigated, settled and

Review of the Company's 2002 A/S indicated that the initial TAC was \$13,783,814, and. the ACLR \$6,614,690. The calculated RBC was 208%, or at Adequate Level according to the Model Act.

Upon request from the NAIC, an amended RBC report was filed by the Company. The TAC; was the same; changes made in the report decreased the ACLR to \$6,447,317. The amended RBC was 214%, or at Adequate Level.

The ratio of the TAC of \$12,752,814 to the amended ACLR of \$6,447,317, would put the RBC at an elevated level of 198%, or at Company Action Level. Consequently, the Company will be required to submit an RBC plan to the Commissioner as determined by ALA. CODE § 27-2B-4(b) (1975).

The Company relied upon its outside actuary to arrive at its estimates for loss and LAE reserves which were set within the outside actuary's reasonable range on both a gross and a net basis. These estimates were lower than those arrived at by the ALDOI's actuaries, resulting in the Company's reserves being determined to be deficient as of December 31, 2002 based upon the calculations of the ALDOI's actuaries. The Company continues to dispute the estimates calculated by the ALDOI's consulting actuary and the ALDOI's contention that it is at Company Action Level. Even allowing for the ALDOI's actuaries' estimates, a decrease in estimated reserves of \$165,000 (or 1.8%) from \$9,116,034 to \$8,951,034 would return the Company's RBC to Adequate Level.

Cash and short-term investments

It was noted that at December 31, 2002, the Company's investments in Whitney Bank still exceeded the investment limitations as defined in ALA. CODE § 27-41-6(a) (1975). At March 31, 2003, however, details concerning these investments established that the Company was then in compliance with the aforementioned section of the *Alabama Insurance Code*.

Guaranty funds receivable or on deposit

The \$594,419 balance at June 30, 2002, for the Louisiana insurance guaranty association was written-off in the 4th quarter of 2002. The \$60,254 balance reported on page 2, line 16, of the 2002 Annual Statement represented the remaining balance of the assessment carried in the books for the Alabama insurance guaranty association. The remaining \$52,724 balance was not admitted in the Company's *Quarterly Statement as of June 30, 2003*.

Losses and Loss adjustment expenses

The actuarial examiners reviewed the Company's actuarial loss and LAE data as of December 31, 2002, and determined that the amounts for *Losses* and *Loss adjustment expenses* were deficient. The table below summarizes the Company's carried liabilities, the actuarial examiner's independent estimate of those liabilities, and the appointed actuary's estimates as documented in his actuarial report:

FOR SETTLEMENT PURPOSES ONLY
WITHOUT PREJUDICE COMMUNICATION

Exhibit B

Cover Page and Page 10 of Report of Examination as of March 31, 2001

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

Report of Limited Scope Examination

of

SOUTHERN UNITED FIRE INSURANCE COMPANY

Mobile, Alabama

as of

March 31, 2001

- e. claims management and adjustment services
 - f. telephone services
 - g. postage
- CIMC agreed to provide the Company at no additional cost the following facilities and any additional facilities reasonably related thereto:
 - a. office space
 - b. books, periodicals and subscriptions to trade publications
 - c. office furniture and equipment
 - d. casualty insurance coverage
 - e. general purpose supplies and printed materials (including supplies and printed materials specially related to Company's business, such as policy and claims forms).

The agreement was filed for approval on "Form D Prior Notice of a Transaction," in accordance with Alabama Department of Insurance Regulation No 55, and Section 27-29-5(b)(4), Code of Alabama 1975, as amended.

A review was conducted to determine that commission expenses paid to producing agents and the sliding servicing fees on the direct and assumed written premiums for the accounting year 2000 was reimbursed by the Company in accordance with this agreement. The examiners recalculated the servicing fees based on the agreed percentage and noted that the recalculated amount did not agree with the amount reported in *Schedule Y* of the year 2000 Annual Statement. This issue was also addressed in the examination of "Payable to parent, subsidiaries and affiliates." Additional information on this matter may be found in the NOTES TO FINANCIAL STATEMENT section of this report, under that caption.

Tax Allocation Agreement:

The tax allocation agreement was executed by Kingsway America, Inc. ("Parent") on February 2, 1999, with eighteen members of the affiliated group (Subsidiaries) being parties to the agreement. Various addenda were made to the original agreement during the year, which bound ten more members of the affiliated group to the agreement.

The affiliated group of companies subjected to the agreement would be required to file a consolidated income tax return for subsequent taxable periods unless the Parent and the Subsidiaries agreed in writing to terminate the agreement. Notwithstanding such termination, this agreement would continue in effect with respect to any

Edwards & Angell LLP

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www.EdwardsAngell.com

CC: Anne Ward ✓
Jack Brown ✓
Ken Smithson ✓

Date : February 23, 2004

From : Lewis Fickett

Fax : (888) 325-9140

Direct : (212) 756-0202

To : John Davis, Esq.

Fax : (334) 240-7581

Direct : (334) 269-3550

To : Richard Murray

Fax : (251) 662-6533

Direct : (251) 662-6602

To :

Fax :

Direct :

Pages : 3

(including cover sheet)

If you received a partial delivery, please call _____ at _____.

Re:

Fax

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Edwards & Angell LLP

750 Lexington Avenue New York, NY 10022 212.308.4411 fax 212.308.4844

Nick Pearson
212.756.0275
fax 212.308.4844
npearson@EdwardsAngell.com

February 23, 2004

VIA FACSIMILE (334) 240-7581
CONFIRMATION BY FEDEXJohn Davis, Esq.
Legal Division
Alabama Department of Insurance
201 Monroe Street, Ste. 1700
Montgomery, AL 36104Re: Southern United Fire Insurance Company ("SUFI") Examination Report

Dear John:

Per our conversation, I am writing to you to request the addition of information regarding SUFI's risk-based capital ("RBC") status as of December 31, 2003 to SUFI's examination report sent to Richard Murray on January 26, 2004 (the "Exam Report") before that report is filed as a public document.

The Exam Report covers the period from January 1, 1998 to June 30, 2002. In the "Subsequent Events" section on page 84 of the Exam Report, the Department discussed SUFI's RBC status through December 31, 2002. As of December 31, 2002, the Department characterized SUFI as being at "Company Action Level" with a RBC level of 198%.

As a result of events occurring during the intervening year, SUFI's RBC status has improved significantly. As of December 31, 2003, SUFI's "Total Adjusted Capital" ("TAC") was \$19,118,858 and its "Authorized Control Level Risk" ("ACLR") was \$3,497,651. The ratio of the TAC to the ACLR was 5.47, yielding a RBC of 547% which is "Adequate Level."

We would request that the Department revise the RBC section of the Exam Report to read as set forth below. Language we propose removing from the Exam Report prior to the issuance and filing of the final examination report has been struck through and language we propose adding to the Exam Report prior to the issuance and filing of a final report has been inserted in double underlined text.

A review of the carried loss and LAE reserves in the December 31, 2002 Annual Statement (2002 A/S), was made by the Department's consulting actuaries (actuaries), as requested by the Chief Examiner of the ALDOI. Based on the review of the workpapers provided by the Company's opining actuary, the loss and LAE reserves of \$8,104,034 were found to be deficient. An independent

Edwards & Angell

February 23, 2004

Page 2

estimate by the actuaries determined that the loss and LAE reserves were deficient by \$1,012,000, and the contingent commissions liability deficient by \$19,000.

Surplus as regards to policyholders in the 2002 A/S, was reported to be \$13,783,814; adjustments of \$1,031,000 [$\$1,012,000 + \$19,000$] will reduce the *Surplus as regards policyholders* and the TAC to \$12,752,814.

Review of the Company's 2002 A/S indicated that the initial TAC was \$13,783,814, and the ACLR \$6,614,690. The calculated RBC was 208%, or at Adequate Level according to the Model Act.

Upon request from the NAIC, an amended RBC report was filed by the Company. The TAC was the same; changes made in the report decreased the ACLR to \$6,447,317. The amended RBC was 214%, or at Adequate Level.

Consequently, as of December 31, 2002, the ratio of the TAC of \$12,752,814 to the amended ACLR of \$6,447,317, would put the RBC at an elevated level of 198%, or at Company Action Level. Consequently, the Company will be required to submit an RBC plan to the Commissioner as determined by ALA CODE § 27-2B 4(b) (1975). However, a review of the data reported in the Company's Annual Statement as of December 31, 2003 indicated that the TAC was \$19,118,858 and the ACLR was \$3,497,651. The calculated RBC was 547% which is Adequate Level according to the Model Act.

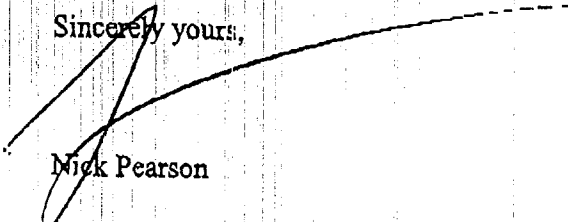
If the Department revises the RBC portion of the "Subsequent Events" section of the Exam Report, SUFI will gladly withdraw its objection to the Exam Report and its request for a hearing.

Please feel free to contact me to discuss our proposed changes outlined above.

Many thanks for your continuing assistance in these matters.

Best regards.

Sincerely yours,



Nick Pearson

cc: Richard Murray

2. Ford



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
LEGAL DIVISION

201 MONROE STREET, SUITE 1700
POST OFFICE BOX 303351
MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 241-4116
FACSIMILE: (334) 240-7581
INTERNET: www.aldoi.gov

March 16, 2004

WALTER A. BELL
COMMISSIONER

GENERAL COUNSEL
MICHAEL A. BOWNES

COUNSEL
TERRY RAYCRAFT
ELIZABETH BOOKWALTER
RALPH R. NORMAN, III
JOHN J. DAVIS
RYAN DONALDSON
VINCENT R. LEDLOW

LEGAL RESEARCH ASSISTANT
STACY FARRIS

Mr. Lewis Fickett III
Edwards & Angell LLP
Via facsimile (212) 308-4844

Re: Southern United Fire Insurance Company ("SUFI")

Dear Lewis:

The purpose of this letter is to confirm our telephone conversation during which I informed you that the Department's Examiners have agreed to make the changes requested by the company with regards to the Examination Report as requested in a letter from Nick Pearson to the Department. Obviously, we will need to work out the details and make sure that our understandings are correct with regards to these changes. We will be forwarding you documents shortly to confirm these understandings. Once this matter has been confirmed in writing and is acceptable to both parties, we will bring this matter to a conclusion quickly. I appreciate your patience and understanding.

Sincerely,

John J. Davis
Associate Counsel

Cc: Alabama Department of Insurance Examiners



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
POST OFFICE BOX 303351
MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 269-3550
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INTERNET: www.aldoi.gov

March 19, 2004

WALTER A. BELL
COMMISSIONER
ASSISTANT COMMISSIONER
RAGAN INGRAM
DEPUTY COMMISSIONERS
D. DAVID PARSONS
JAMES R. (JOHNNY) JOHNSON
CHIEF EXAMINER
RICHARD L. FORD
STATE FIRE MARSHAL (ACTING)
RICHARD MONTGOMERY
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

Mr. Richard Murray
Vice President and Chief Operating Officer
Southern United Fire Insurance Company
One Southern Way
Mobile, AL 36619

Re: Revised Examination Report pages 12 and 84

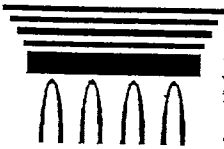
Dear Mr. Murray:

Enclosed please find revised pages 12 and 84 for the June 30, 2002 examination report. We understand that if you find these acceptable you will withdraw your request for a hearing on this report's findings.

We will hold this in abeyance until March 29, 2004 for your reply.

Sincerely,

Richard L. Ford, CFE, CIE
Chief Examiner



**SOUTHERN
UNITED**
ESTABLISHED 1903

www.southernunited.com

March 29, 2004

One Southern Way
Post Office Box 190429
Mobile, Alabama 36619

Richard L. Ford, CFE, CIE
Chief Examiner
Department of Insurance
State of Alabama
201 Monroe Street, Suite 1700
Montgomery, Alabama 36130-3351

Re: Southern United Fire Insurance Company ("SUFI")
Revised Examination Report

Dear Mr. Ford:

Thank you for your letter of March 19th enclosing the revised language for pages 12 and 84 for the June 30, 2002 Examination Report. We find these changes acceptable and we hereby withdraw our request for a hearing on the Report's findings, with the understanding that the Department has concluded that it will not pursue any administrative penalty against SUFI in conjunction with the Report's findings relating to and arising out of the Management Agreement between SUFI and Consolidated Insurance Management Corporation and the parties conduct thereunder.

We appreciate the Department's assistance in concluding this matter.

Best regards.

Very truly yours,

Richard D. Murray

Cc: J. Davis
N. Pearson

Customer Service (800) 851-9476 - (800) 677-7834

Claims Fax (800) 477-7834 • Underwriting Fax (251) 662-6563 • Marketing Fax (251) 662-6562 • Human Resources Fax (251) 662-6533

NYC: NYC 173795 / NIPERSON



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BEFORE THE INSURANCE COMMISSIONER
OF THE
STATE OF ALABAMA

WALTER A. BELL
COMMISSIONER
ASSISTANT COMMISSIONER
RAGAN INGRAM
DEPUTY COMMISSIONERS
D. DAVID PARSONS
JAMES R. (JOHNNY) JOHNSON
CHIEF EXAMINER
RICHARD L. FORD
STATE FIRE MARSHAL (ACTING)
RICHARD MONTGOMERY
GENERAL COUNSEL
MICHAEL A. BOWNES
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

IN THE MATTER OF:)
FINANCIAL CONDITION EXAMINATION OF)
SOUTHERN UNITED FIRE INSURANCE COMPANY)
AS OF JUNE 30, 2002)

ORDER

ON THE 17th day of March, 2004, the above entitled cause came on for consideration by the Insurance Commissioner, pursuant to Regulation 103. The Insurance Commissioner, having fully considered and reviewed the Examination Report together with any written submissions or written rebuttals and any relevant portions of the examiners' workpapers, finds and states as follows, to-wit:

JURISDICTION

1. That the Insurance Commissioner has jurisdiction of this cause, pursuant to the provisions of the Alabama Insurance Code.
2. That Southern United Fire Insurance Company is a domestic insurer licensed for property and miscellaneous casualty, excluding official surety bonds in the State of Alabama.

ORDER
FINANCIAL CONDITION EXAMINATION
PAGE 2

FINDINGS OF FACT

1. That on January 26, 2004, the verified Financial Condition Examination Report of Southern United Fire Insurance Company was filed with the Insurance Department.

2. That following receipt of the June 30, 2002 Examination Report, the Company was afforded a reasonable opportunity of not more than twenty (20) days to make a written submission or written rebuttal with respect to any matters contained in the Examination Report.

3. That Regulation 103 provides that within twenty (20) days of the end of the period allowed for the receipt of written submissions or written rebuttals, the Insurance Commissioner shall fully consider and review the report, together with any written submissions or written rebuttals and any relevant portions of the examiners' workpapers and enter an order. The order shall either: (i) adopt the examination report as filed or with modifications or corrections, including an order that the company take actions to cure any violations; (ii) reject the examination report with directions to the examiners to reopen the examination for purposes of obtaining additional data, documentation or information; or (iii) call for an investigatory hearing for purposes of obtaining additional documentation, data, information and testimony.

4. Regulation 103 requires the company to file affidavits executed by each of its directors stating under oath that they have received a copy of the adopted report and related orders within thirty (30) days of the issuance of the adopted report.

CONCLUSIONS OF LAW

1. That the June 30, 2002 Financial Condition Examination Report of Southern United Fire Insurance Company shall be and hereby is Adopted by the Insurance Commissioner, pursuant to Regulation 103.

ORDER
FINANCIAL CONDITION EXAMINATION
PAGE 3

ORDER

IT IS THEREFORE ORDERED by the Commissioner of Insurance as follows:

1. That the June 30, 2002 Financial Condition Examination Report of Southern United Fire Insurance Company is hereby Adopted.
2. That Southern United Fire Insurance Company file an affidavit with the Alabama Department of Insurance stating that a copy of the adopted report and related orders were reviewed by the board of directors within thirty (30) days of the issuance of the adopted report.
3. That Southern United Fire Insurance Company file an affidavit with the Department of Insurance within thirty (30) days of the issuance of the adopted report that the company filed a copy of the adopted report and related orders with all licensing states and the NAIC. An affidavit form is attached.
4. That Southern United Fire Insurance Company shall comply with the recommendations set forth in the Report of Examination, and that failure by Southern United Fire Insurance Company to so comply may result in sanctions or administrative action; and further, that Southern United Fire Insurance Company shall file with the Department of Insurance within thirty (30) days of the order a statement signed by an appropriate official of the company stating the corrective action taken to comply with the recommendations made in the Report of Examination.

WITNESS My Hand and Official Seal this 17th day of March, 2004.

(SEAL)



Walter A. Bell
Insurance Commissioner
201 Monroe Street, Suite 1700
Montgomery, Alabama 36130
(334) 269-3550

CERTIFICATION

I, _____ (office) of
_____ Company, do hereby certify that the Report of Examination of
_____ Company as of _____, _____, was filed with all states
in which _____ Company is licensed, and with the office of the National Association
of Insurance Commissioners.

By: _____

Sworn and subscribed before the undersigned authority on the ____ day of _____, 2004.

Seal

Notary

SENDER: COMPLETE THIS SECTION

- Complete items 1, 2, and 3. Also complete item 4 if Restricted Delivery is desired.
- Print your name and address on the reverse so that we can return the card to you.
- Attach this card to the back of the mailpiece, or on the front if space permits.

1. Article Addressed to:

Mr. Matthew P. Merlino
Merlinos & Associates, Inc.
3274-B Medlock Bridge Road
Norcross, GA 30092

COMPLETE THIS SECTION ON DELIVERY

A. Received by (Please Print Clearly) B. Date of Delivery

D. Hamilton 3-25-04

C. Signature

x D. Hamilton

☐ Agent
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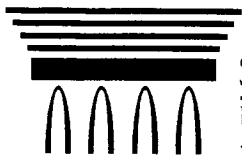
2. Article Number (Copy from service label)

7002 2030 0000 9484 2281

PS Form 3811, July 1999

Domestic Return Receipt

102595-00-M-0952



**SOUTHERN
UNITED**
ESTABLISHED 1963

www.southernunited.com

One Southern Way
Post Office Box 190429
Mobile, Alabama 36619

April 20, 2004

Walter A. Bell, Insurance Commissioner
State of Alabama
Department of Insurance
201 Monroe Street, Suite 1700
Montgomery, Alabama 36130-3351

RECEIVED BY US MAIL OR
COMMERCIAL COURIER SERVICE

APR 21 2004

Re: Financial Condition Examination of
Southern United Fire Insurance Company
As of June 30, 2002

ALABAMA DEPT OF INSURANCE
EXAMINERS DIVISION

Commissioner Bell:

Enclosed is the response, on behalf of Southern United Fire Insurance Company, to the recommendations made in the above-cited audit. As this document will show, we have or are addressing all recommendations made within the audit. As you will see from this document our approach to compliance was to enhance and improve our system, create controls and procedures and increase individual accountability to meet defined quality standards. We truly believe we have put in place mechanisms and people, which will keep us in compliance for all identified areas.

We have enclosed the required signed affidavits attesting to the fact that we have filed with the licensing states and the NAIC, as well as provided to our Board of Directors, a copy of the adopted report and related orders.

If you should have any questions or need additional information please let us know.

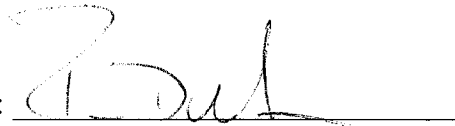
Sincerely

Richard D. Murray
President & CEO
Southern United Fire Insurance Company

CERTIFICATION

I, Richard D. Murray, President of Southern United Fire Insurance Company, do hereby certify that the Report of Examination of Southern United Fire Insurance Company as of June 30, 2002, was filed with all states in which Southern United Fire Insurance Company is licensed, and with the office of the National Association of Insurance Commissioners.

BY: _____



Sworn to and subscribed before the undersigned authority on the 19th day of April, 2004.

(S E A L)

Notary

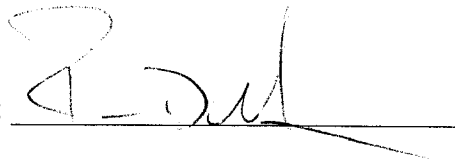


NOTARY PUBLIC STATE OF ALABAMA AT LARGE
MY COMMISSION EXPIRES: Mar 31, 2007
BONDED THRU NOTARY PUBLIC UNDERWRITERS

AFFIDAVIT
BOARD OF DIRECTORS

I, Richard D. Murray, President of Southern United Fire Insurance Company, do hereby certify that the Report of Examination of Southern United Fire Insurance Company as of June 30, 2002 and, related orders were distributed to its Board of Directors. This report will be attached to the minutes of the next Board meeting.

BY: _____



Sworn to and subscribed before the undersigned authority on the 19th day of April, 2004.

(S E A L)

Notary Public

NOTARY PUBLIC STATE OF ALABAMA AT LARGE
MY COMMISSION EXPIRES: Mar 31, 2007
BONDED THRU NOTARY PUBLIC UNDERWRITERS

**Southern United Fire Insurance Company
Response to the Recommendations
Of**

**State of Alabama
Department of Insurance
Report of Association Examination
Of
Southern United Fire Insurance Company
Mobile, Alabama
As of
June 30, 2002**

We, at Southern United Fire Insurance Company, would like to thank the individuals of the Alabama Department of Insurance for their patience, cooperation and assistance throughout this audit and for identifying those areas that needed to be corrected or improved within our organization. While the audit process was detailed and demanding, it has created a very accurate “roadmap to compliance” for us to follow. It is our intent to comply with all recommendations within the report. We are hopeful that since the change in management, it is evident we have taken an approach to the audit process that will enable us to accomplish this in its entirety.

Throughout the audit as problems were identified which could be corrected immediately, they were and consequently acknowledged with a subsequent event comment. As indicated in the audit report the recommendations from the previous audit, which had not been addressed, were again cited under the current comments and recommendations. A summary of the processes, controls and remedies for the issues cited as current recommendations are explained below.

Holding Company and Affiliate Matters

Transactions and Agreements with Affiliates:

Management Services and Facilities Agreement – Page 10

It is recommended that the Company submit all management agreements, service contracts, and cost-sharing arrangements to the ALDOI in accordance with ALA. CODE § 27-29-5 (1975), and ALDOI *Regulation No. 55*.

It is recommended that the Company not pay any fees without an approved management agreement in place and refrain from paying fees, other than submitted and approved dividends, until a management agreement has been approved by the ALDOI in accordance with the aforementioned regulatory authorities.

It is recommended that the Company detail its MGA arrangement with CIMC in a written contract in accordance with ALA. CODE 27-6A-4 and 27-29-5(4) (1975).

It is recommended that the Company license and appoint its MGA, and/or any other person to which commissions are paid, in accordance with ALA. CODE § 27-6A-3 and 27-7-4(b) (1975).

It is recommended that the Company pay commissions to only those persons holding a current valid license in accordance with ALA. CODE § 27-7-4.1(a) (1975).

SUFI RESPONSE:

We have agreed to the ALDOI's recommended option to dissolve CIMC and transfer all functionality, personnel and costs to SUFI. Our attorneys are currently reviewing all contracts, leases, and accounts, etc. to determine how to best accomplish this.

Market Conduct Activities

Treatment of Policyholders and Claimants:

Complaint Handling – Page 19

Complaint log and documentation – Page 19

It is recommended that the Company keep complete and accurate documentation as required by ALA. CODE § 27-27-29(a) (1975) and follow through to ensure that all complaints are recorded on the complaint log in accordance with Complaint Handling Standard 1 in the NAIC Market Conduct Handbook.

Complaint procedures manual – Page 20

It is recommended that the Company maintain a complaint handling procedures manual and communicate such procedures to policyholders, as defined by Complaint Handling Standard 2 of the NAIC Market Conduct Handbook.

Complaint documentation – Page 20

It is recommended that the Company keep complete records for complaints received from consumers and the ALDOI, in accordance with Complaint Handling Standard 3 of the NAIC Market Conduct Handbook, and ALA. CODE 27-27-29(a) (1975) for the maintenance of records.

Resolution of complaints – Page 20

It is recommended that the Company respond to all complaint inquiries received by the ALDOI within the 10-day time frame as required by ALDOI *Regulation No. 118*, and within a reasonable time to the complainant.

It is recommended that the Company develop and utilize a policy specifying a reasonable time frame for the timely response and resolution concerning the handling of complaints; per Complaint Handling Standard 4 of the NAIC Market Conduct Handbook.

Subsequent complaints – Page 20

It is recommended that the Company maintain complete records as defined by ALA. CODE § 27-27-29(a) (1975) and log any communication received from the ALDOI on the complaint log in accordance with Complaint Handling standards in the NAIC Market Conduct Handbook.

SUFI RESPONSE:

We have created a complaint handling procedure with input from all the departments involved and using the NAIC handbook as our basis. The procedures were put into effect as of January 1, 2004. We have taken our prior year records and resorted them by state as discussed. As recommended in the NAIC handbook, we have established periodic reviews by senior management to review the complaints and insure the complaints are being handled according to the established procedures, to monitor timeliness of the response and the quality. This review also allows us to identify any adverse trends that may develop within the departments. We are confident this will alleviate the problem going forward.

Policyholder Service – Page 21

Discrepancies of Cancellation methods – Page 21

It is recommended that the Company continue to use the pro rata method of cancellation that was begun on September 22, 1998. When this matter was discussed with Company officials, the Company indicated that it changed to the pro rata method of cancellation in the best interest of the customers. The Company has filed with the ALDOI to correct its underwriting guidelines to reflect the pro rata method for insured requested cancellations, effective April 1, 2003.

SUFI Response:

As indicated within the audit report, this has been corrected.

Proof of mailing for lien holders – Page 22

It is recommended that the Company monitor the finance company and other agencies to ensure that cancellation notices are being sent on a timely basis to governmental agencies, mortgagees or other third parties, in accordance with ALA. CODE § 27-40-11(d) (1975).

It is recommended that the Company maintain documentation of proof of mailing by the finance company or agencies that mail the cancellation notices to the governmental agency, mortgagee or other third parties as required by ALA. CODE § 27-27-29 (1975), and Policyholder Service Standard 1 of the NAIC Market Conduct Handbook.

SUFI Response:

The only premium finance company SUFI accepts in Alabama is Time Payment Plan. Southern United Holding, which is SUFI's immediate parent, owns Time

Payment Plan. We have modified the procedures in Time Payment Plan to include the sending of lien holder notification with proof of mailing . This is currently being done manually. We are waiting for the requested changes to be made on the software Time Payment uses to simplify this requirement.

Compliance with Agents' Licensing Requirements:

Producer Licensing – Page 24

Producer licenses and appointments - Page 24

It is recommended that the Company monitor its agents on a regular basis to assure that they are properly licensed and appointed as defined in ALA. CODE § 27-7-4(1975) *License requirement*, ALA. CODE § 27-7-30 (1975) *Producer Appointment; termination of appointment*, and Producer Licensing Standards 1 and 2 of the NAIC Market Conduct Handbook. During the course of the examination, Company officials indicated that corrective action would be taken.

Agents' commissions – Page 25

It is recommended that the Company monitor its agents on a regular basis to assure that they are properly licensed and appointed as required by ALA. CODE §§ 27-7-4 *License Requirement* 27-7-30 *Producer Appointment*; 27-7-29.2 *Assumed business name*; and 27-7-4.1(a) *Commissions*, (1975), ALDOI Bulletin (AB-107) *Agents Doing Business Under Other Names*, and Producer Licensing Standard 2 of the NAIC Market Conduct Handbook.

It is recommended that the Company maintain producer records and correct information in its hard copy and computer data files in accordance with ALA. CODE § 27-27-29(a) (1975) *Maintenance of records*.

Producer Terminations – Page 25

Termination of producers – Page 25

It is recommended that the Company monitor on a regular basis the termination of producers and send proper notification to the producers and the ALDOI as required by ALA. CODE §§ 27-7-30(e), and 27-7-30.1 (a) (1975).

Terminated Producer documentation – Page 25

It is recommended that the Company monitor on a regular basis the termination of producers and send proper notification to the producers and the ALDOI, as specified by Producer Licensing Standard 3 of the NAIC Market Conduct Handbook, and ALA. CODE §§ 27-7-30(e) and 27-7-30.1 (a) (1975).

It is recommended that the Company have a determined way of monitoring agents on a regular basis to assure that they are properly licensed and appointed as required by ALA. CODE § 27-7-4 (1975) *License Requirement*, ALA. CODE § 27-7-30 (1975) *Producer Appointment*, and Producer Licensing Standard 2 of the NAIC Market Conduct Handbook. Subsequent to the June 30, 2002 examination period, Company officials indicated that corrective actions have been taken to improve the monitoring and maintenance of producers.

It is recommended that the Company maintain complete and accurate records as required by ALA. CODE § 27-27-29(a) (1975) for its hard copy and computer data files.

SUFI Response:

We have put a huge effort into bringing our Alabama agent and agency licensing into compliance. We have contacted all of our active agencies and updated the licensing of all agents within the agency that produce any business for SUFI. We have appointed with the state all of the agents that were not previously appointed with us and we have sent termination notices to the state for those agents that are no longer representing SUFI. To maintain our current status on agent licensing we have modified our computer to allow us to list all appointed agents within an agency. When an application is being processed, the agency number is entered and a listing of all appointed agents within that office is in a drop down box. The list of agents is compared to the signing agent on the application to assure that agent is appointed with our company prior to issuing the policy. Therefore, agents that submit applications that are not appointed with us will be contacted to fill out the appropriate form for appointment and be added to our appointments.

The appointment of the agencies is now completed. We have requested copies of their agency's license and supplemented this information using the ALDOI website to obtain the information. All but 10 have responded and we have again contacted those. We will now send out a final letter indicating that their agency is required to be licensed and we are required to have them appointed. If they do not provide us with a copy of the business license application and the check, we will terminate their contract with SUFI.

On a monthly basis, we will now begin to run a renewal listing for both the agents and agencies to determine they have renewed these licenses as they come due. This will be done in conjunction with the ALDOI website and the expiration roster provided by the state.

We have also created the means for our marketing representatives to check the appointed agents within an agency they are visiting. If there are new agents within the office that we are not aware of, they will get the paperwork filled out and we will have them appointed. They will also let us know if appointed agents have left the agency.

Annually, we will do an update request to identify agents that are appointed with us that no longer work at the agency.

We are confident that through these system enhancements and procedures, we will remain in compliance going forward.

Underwriting and Rating:

Active Policies – Page 26

Rating Practices and Underwriting Practices – Pages 26 and 28

It is recommended that the Company charge rates for policy coverage based on rates filed in accordance with ALA. CODE §§ 27-2-17, 27-13-4 (1975), ALA. ADMIN. CODE 482-1-123 (2001), the March 31, 2001 Bulletin, and Underwriting and Rating Standard 11 of the NAIC Market Conduct Handbook.

SUFI Response:

The rating errors were as follows. On three policies the underwriter selected from a list the wrong vehicle surcharge to apply to the policy. These were manual errors. We have created surcharge tables within the computer system to assign the correct surcharge based upon the vehicle's VIN. The one incorrect zip code was a newly created zip code since our last rate filing. We add the new zip codes and assign the rating territory based upon the rating territory of the contiguous zip codes. These new zip codes are added to our territory definitions at the next filing. It is our understanding that is correct according to the rates and forms filing area at the ALDOI. As recommended, we will put this procedure into our next filing manual later this year. The one incorrect violation surcharge was a manual input error. Since the time of that error, we have modified our computer system to assign the surcharge based upon the violation entered. This will eliminate human error in the future.

It is recommended that the Company maintain complete records of its underwriting transactions and affairs for at least five years in accordance with ALA. CODE § 2727-29 (1975), ALDOI *Regulation No. 118*, and Underwriting and Rating Standard 15 of the NAIC Market Conduct Handbook.

SUFI Response:

It is our procedure to order the MVR online, print it and attach it to the application. Our assumption is the lack of an MVR for 3 files was a manual error. We now address issues like this through a weekly quality review on each individual involved in the process. This allows an immediate correction for the individual and accumulated identifies areas for future training of the department as a whole. The results of these reviews are a part of the individual's performance reviews.

Cancelled/Terminated Policies – Page 29

First Sixty Days Cancellations – Page 29

It is recommended that the Company maintain complete records of its underwriting transactions and affairs in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, and the Company's U/W Manual.

It is recommended that the Company provide the correct reasons for cancellation on all notices of cancellation in accordance with policy provisions, state laws, Company guidelines, and relevant NAIC Underwriting and Rating Standards.

Non-renewals and Cancellations of Sixty Days or More – Page 31

It is recommended that the Company maintain complete records of its underwriting transactions and affairs in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*; the Company's U/W Manual, and applicable NAIC Underwriting and Rating Standards.

SUFI Response:

We believe this problem is a result of “hard copy” storage issues for the older years examined. Since those times, SUFI has established a document management system (DMS). The DMS was implemented in April 2002 and all records of transactions generated by the system are backed up nightly. This system stores the records in an unchangeable PDF format, which is retrievable from an individual's desktop. We continue to enhance and increase the electronic storage capabilities of the system to retain complete documentation.

Claims Payment Practices

Paid Claims – Page 32

Timely Communications – Page 32

It is recommended that the Company insure that initial contact by the Company with the claimant is within the required time frame in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003), and Claims Standard I of the NAIC Market Conduct Handbook.

SUFI Response:

Metrics have been put in place for all adjusters to make initial contact within 24 hours on 85% of their file assignments. This is measured on a weekly basis so that failure to accomplish this is recognized immediately. The adjuster's performance in this area is part of their performance review process.

It is recommended that the Company insure that it responds to pertinent claims communications in a timely manner in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003), and Claims Standard 4 of the NAIC Market Conduct Handbook.

SUFI Response:

A monthly audit process has been put in place that will identify adjusters that do not meet this requirement. Delays in response times are identified and addressed with the adjuster on the same monthly basis. The supervisor addresses all issues in a monthly coaching meeting with each adjuster.

Timely Resolutions – Page 33

It is recommended that the Company insure that its claims resolutions, i.e., liability determinations, coverage questions, claim payments, etc., are made in accordance with the relevant sections of ALA. ADMIN. CODE 482-1-125 (2003), and Claims Standards 2 and 3 of the NAIC Market Conduct Handbook.

SUFI Response:

Metrics have been put in place for all adjusters with varying timeframes dependent upon the coverage. All metrics goals are in compliance with the NAIC Market Conduct Handbook. This is measured monthly through system-generated reports and monthly file reviews. Issues are addressed in the adjuster's monthly coaching session and results are taken into consideration in adjuster's performance review.

Adequate file documentation – Page 34

It is recommended that the Company maintain complete and accurate records of its claims transactions in accordance with ALA. CODE § 27-27-29 (1975), ALDOI *Regulation No. 118*, and Claims Standard 5 of the NAIC Market Conduct Handbook. This recommendation was also made in the previous examination report. ALA. ADMIN. CODE 482-1-125-.04 (2003) also defines the maintenance of claims files so that data is accessible and retrievable for examination purposes.

SUFI Response:

The monthly file review by supervisors includes file documentation, as well as the adequacy of system-retained notes to the file. Deficiencies in either area are addressed in the monthly coaching session with each adjuster.

Paid Claims – Based on policy provisions, ALDOI statutes, etc. – Page 35

It is recommended that the Company include the disclosure statement regarding non-original equipment manufacturer aftermarket crash parts with its written estimates in accordance with ALA. CODE § 32-17A-3 (1975). This recommendation was also made in the previous examination report.

SUFI Response:

We have addressed this issue with all of the independent appraisers throughout the state and our internal property damage auditors monitor compliance via their appraisal audits.

It is recommended that the Company account for and properly document its replacement check and voided check transactions in accordance with ALA. CODE § 27-36-1 (1975), *SSAP No. 5*, of the AP&P Manual, the A/S Instructions, and SUFI's "Transactions Types" guidelines.

It is also recommended that unclaimed property (claims checks) be reported as *Amounts withheld or retained by company for account of others*, and escheated to the State of Alabama in accordance with ALA. CODE § 35-12-31 (1975), *ALDOI Regulation No. 66*, and A/S Instructions.

SUFI Response:

Currently SUFI does not have this on the correct line on the balance sheet. We will re-class from one balance sheet account to the other by the 1st quarter of 2004.

Denied claims – Page 36

Acknowledgement of Pertinent Communications – Page 36

It is recommended that the Company insure that initial contact by the Company with the claimant is within the required time frame in accordance with ALA. ADMIN. CODE 482-1-125-.06 (2003), and Claims Standard 1 of the NAIC Market Conduct Handbook.

SUFI Response:

Metrics have been put in place for all adjusters to make initial contact within 24 hours on 85% of their file assignments. This is measured on a weekly basis so that failure to accomplish this is recognized immediately. The adjuster's performance in this area is part of their review process.

It is recommended that the Company insure that it responds to pertinent claims communications in a timely manner in accordance with ALA. ADMIN. CODE Chapters 482-1-125-.06, and 482-1-125-.07 (2003), and Claims Standard 4 of the NAIC Market Conduct Handbook.

SUFI Response:

A monthly audit process has been put in place that will identify adjusters that do not meet this requirement. Delays in responses or no response issues are identified immediately and addressed with the adjuster on the same monthly basis. The supervisor addresses issues in a monthly coaching meeting with each adjuster.

***Claims denied or closed without payment –
Adequate file documentation – Page 37***

It is recommended that the Company maintain complete and accurate records of its denied and/or closed-without payment claims files and transactions in accordance with ALA. CODE § 27-27-29 (1975), ALDOI Regulation No. 718, policy provisions, and Claims Standards 5 and 11 of the NAIC Market Conduct Handbook. ALA. ADMIN. CODE 482-1-125-.04 (2003) also defines the maintenance of claims files so that data is accessible and retrievable for examination purposes.

SUFI Response:

For this issue, as with most the issues listed above, SUFI is relying heavily on the supervision and auditing of their adjusters. The timeliness and the quality of handling is being addressed by their immediate supervisor through weekly and monthly audits. SUFI has implemented strict metrics, which exceed the requirements of Alabama statutes and the NAIC Handbook. The metric and audit results are addressed with the adjuster on a timely basis and each adjuster is aware of the expectations. The result of the audits are an integral part of the performance review process.

Accounts and Records – Page 45

It is recommended that the Company provide all requested information to the examiners in a timely manner in accordance with ALDOI Regulation No. 118.

SUFI Response:

With the change of management, we believe the response times to auditor's requests improved and can guarantee that you will not experience the same problem in future audits.

Bonds – Page 52

It is recommended that the Company amortize its bonds to the call or maturity value/date in accordance with the SSAP No. 26, Section 6, of the AP&P Manual.

It is recommended that the Company use the scientific (constant yield) interest method in accordance with SSAP No. 26, Section 6, of the AP&P Manual.

SUFI Response:

With the change in management and starting with the 2002 annual statement, we began using the Conning Asset Management data in its entirety. This data complies with the above-mentioned recommendations.

Real estate – Page 52

It is recommended that the Company keep updated appraisals for properties that are admitted as assets in accordance with ALA. CODE § 27-37-7(b) (1975), and *SSAP No. 40*, paragraph 12, of the AP&P Manual. If the Company chooses to admit the Commercial Rental Property, a new appraisal should be obtained for said property.

It is recommended that the Company keep complete records including original cost records for all properties owned by the Company in accordance with ALA. CODE § 27-27-29(a) (1975).

It is recommended that the Company keep and maintain all vouchers for any disbursement of \$25.00 or more in accordance with ALA. CODE § 27-27-30(a) (1975).

SUFI Response:

An updated appraisal for the properties was obtained during the audit and we intend to update the appraisals every 3 years thereafter. During the audit, we made every effort to obtain original cost documentation on current properties, but were unable to obtain them. SUFI currently maintains all vouchers on a going forward basis.

Cash and short-term investments – Page 54

It is recommended that the Company refrain from investing its cash in excess of the statutory limitation, as required by ALA. CODE § 27-41-6(a) (1975). Any amount exceeding such guidelines should be not admitted from the balance sheet.

It is recommended that the Company ensure the collateral pledged for the repurchase agreement meets the requirements of *SSAP No. 45* of the AP&P Manual by equaling 102 percent of the purchase price of the underlying security.

It is recommended that the Company report its repurchase agreement transactions under the Investment section of the *General Interrogatories* as required by the A/S Instructions.

It is recommended that the Company properly identify its investments in the appropriate Annual Statement schedules in accordance with NAIC instructions thereto and ALA. CODE § 27-37-1 (1975).

SUFI Response:

We addressed the issue of investing cash in excess of the statutory limitation directly after we were made aware of this issue. We are now aware of SSAP No. 45 and will comply in the future should we find ourselves in the same situation. We will comply in accordance with NAIC instructions on how to properly report the transaction in the annual statement.

Agents' balances or uncollected premiums:

Premiums and agents' balances in course of collection – Page 55

It is recommended that the Company comply with the definition of uncollected premiums in accordance with A/S Instructions and *SSAP No. 6*, of the AP&P Manual.

It is recommended that uncollected premiums that do not meet the criteria of admitted assets, as defined by *SSAP No. 4* of the AP&P Manual, be not admitted from the balance sheet.

SUFI Response:

The error was corrected and a subsequent event was included in the audit report.

Reinsurance recoverables on loss and loss adjustment expenses – Page 57

It is recommended that the Company maintain complete records of its transactions and affairs in accordance with ALA. CODE § 27-27-29(a) (1975).

It is recommended that the Company properly account for overdue recoverables from authorized insurers and report such items in the appropriate part of *Schedule F* in accordance with A/S Instructions, and *SSAP No. 62*, paragraph 19, of the AP&P Manual. The previous examination also made the above recommendations.

It is recommended that the Company not include any other asset other than reinsurance recoverables on loss payments in the referenced line in accordance with A/S Instructions, and *SSAP No. 62*, paragraph 19, of the AP&P Manual.

SUFI Response:

We have complied with these above recommendations in the 2003 annual statement.

Federal and foreign income tax recoverable and interest thereon – Page 58

It is recommended that the Company comply with ALA. CODE § 27-27-29 (a) (1975), and maintain all records pertaining to the Company's operation at its home office within the State of Alabama.

It is also recommended that the Company comply with all aspects of its *Tax Allocation Agreement* and return moneys owed to the Company in accordance with said agreement.

SUFI Response:

We have requested the required tax documentation from our parent in Chicago and will do so for all subsequent years. We have reminded our parent of the 30 day payment requirement and will continue to do so on an ongoing basis.

Guaranty funds receivable or on deposit – Page 59

It is recommended that the Company report guaranty funds in accordance with ALA, CODE § 27-42-8 (1975), and *SSAP No's. 4, 29 and 35*, of the AP&P Manual.

SUFI Response:

The error was corrected and a subsequent event was included in the audit report.

Loss adjustment expenses – Page 62

It is recommended that the Company insure that its reported losses and LAE reserves:

- meet the requirements of the insurance laws of Alabama;
- are computed in accordance with accepted loss reserving standards and principles; and
- make a reasonable provision for all unpaid loss and loss expense obligations under the terms of its policies and agreements.

It is recommended that the Company maintain adequate documentation that supports management's selected reserves as presented in the Company's financial statements in accordance with ALA. CODE §§ 27-27-29, and 27-37-1 (1975), *SSAP No. 55*, of the AP&P Manual, and A/S Instructions.

SUFI Response:

SUFI uses the services of an independent actuarial firm and was approximately \$300K below the midpoint of their recommended range. ALDOI had an independent review done which was higher. In the subsequent year, the IBNR was increased on a diminished book of open reserves. We do not believe we will be deficient on a going forward basis.

**Commissions payable, contingent commissions
and other similar charges** – Page 63

It is recommended that the Company calculate its contingent liability related to the sliding scale commission arrangements in its reinsurance contracts by treaty and by agreement year in order to insure that the results by agreement years do not affect the terms of the other agreement years in accordance with ALA. CODE § 27-36-1 (1975) and *SSAP No. 55*, of the AP&P Manual.

SUFI Response:

This is a direct result of the auditor's higher estimate of the carried loss and loss expense reserves. The method of calculating the liability on SUFI's carried loss and loss expense reserves was determined by the actuarial examiners to be accurate. With the increase in average case reserve and a strengthening of the IBNR carried at year end 2003, we believe that this shortfall has been remedied.

Unearned premiums – Page 64

Advance premium – Page 64

It is recommended that the Company report premiums processed and paid prior to the effective date as *Advance premium* and not *Unearned premiums* in accordance with SSAP No. 53, of the AP&P Manual and A/S Instructions. It is also noted that the previous examination recommended that the Company record unearned premiums when the payments are received in advance; therefore, that recommendation is reiterated.

SUFI Response:

The computer system was modified in November of 2002 to handle advance premiums correctly and will not be an issue going forward.

Amounts withheld or retained by company for account of others – Page 65

It is recommended that the Company establish and maintain a liability for unclaimed property until the appropriate time frame has elapsed to remit said funds to the Alabama Department of Revenue, in accordance with ALDOI *Regulation No. 66*.

SUFI Response:

Currently SUFI does not have this on the correct line on the balance sheet. We will re-class from one balance sheet account to the other by the 1st quarter of 2004.

It is recommended that the Company file the unclaimed property report timely in accordance with ALA. CODE § 35-12-31(d) (1975). **It is also recommended** that the Company file REPORT FORM 1 in the event there is no unclaimed property to be reported in a reporting cycle.

SUFI Response:

All filings will be made timely. SUFI in 2001 had no unclaimed property to file and was unaware that REPORT FORM 1 was to be filed even if there was no unclaimed property. In the event there is no unclaimed to report in the future, we are now aware of the necessity of filing the REPORT FORM 1.

Provision for reinsurance – Page 66

It is recommended that the Company maintain complete records of its transactions and affairs in accordance with ALA. CODE § 27-27-29 (a) (1975).

It is recommended that the Company properly account for overdue recoverables from authorized insurers and report such items in the appropriate part of Schedule F in accordance with A/S Instructions, and *SSAP No. 62*, paragraph 19, of the AP&P Manual. The previous examination also made above recommendations.

It is recommended that the Company not include any other asset other than reinsurance recoverables on loss payments in *Provision for reinsurance* in accordance with A/S Instructions and *SSAP No. 62*, paragraph 19, of the AP&P Manual.

SUFI RESPONSE:

All of the above refer to errors on Schedule F in the 2002 Annual Statement. The recommendations have been incorporated into our Schedule F of the 2003 Annual Statement. Reinsurance records were obtained from the external reinsurance intermediary and utilized in the 2003 schedule. This information obtained accurate aging of recoverable and it was duly recorded in the appropriate part of Schedule F. Other assets, other than reinsurance recoverable, were not included.

Payable to parent, subsidiaries and affiliates – Page 67

It is recommended that the Company comply with ALA. CODE § 27-27-29 (1975), and *SSAP No. 25*, of the AP&P Manual by appropriately recording and reporting intercompany expenses.

SUFI RESPONSE:

An error in commission expense payable to CIMC was omitted for January 2001. Once identified by company management, it was recorded in the 2002 Annual Statement. As such, the correction was noted under subsequent events.

Compliance with ALDOI Regulation No. 60

It is recommended that the Company file future Annual and Quarterly Statements in accordance with the last filed *Report of Examination*, pursuant to *ALDOI Regulation No. 60*, and the *ALDOI Bulletin*, dated January 26, 2000 (Accounting Practices and Procedures Required for Authorized Insurers).

SUFI Response:

SUFI has adhered to all the recommendations of this audit on all subsequent quarterly and annual reporting.

SOUTHERN UNITED FIRE INSURANCE COMPANY

STATEMENT OF INCOME

For Year-to-Date (Quarter Ended June 30, 2002), and
Prior Years Ended December 31, 1998, 1999, 2000, and 2001

	<u>06/30/2002</u>	<u>12/31/2001</u>	<u>12/31/2000</u>	<u>12/31/1999</u>	<u>12/31/1998</u>
<u>Underwriting income</u>					
Premiums earned:					
Direct (current written \$35,561,693)	\$ 35,425,978	\$ 57,080,961	\$ 27,772,985	\$ 33,903,809	\$ 61,250,991
Assumed (current written \$(373))	(373)	2,059,954	9,544,898	2,250,102	71,815
Ceded (current written \$26,678,013)	<u>26,601,752</u>	<u>44,589,840</u>	<u>28,098,312</u>	<u>26,900,034</u>	<u>45,177,409</u>
Net (current written \$8,883,307)	<u>\$ 8,823,853</u>	<u>\$ 14,551,075</u>	<u>\$ 9,219,571</u>	<u>\$ 9,253,877</u>	<u>\$ 16,145,397</u>
<u>Deductions:</u>					
Losses incurred (current accident year \$5,021,765):					
Direct	\$ 23,111,708	\$ 38,863,077	\$ 14,863,168	\$ 21,053,212	\$ 49,352,154
Assumed	133,724	2,950,202	7,979,888	2,077,803	20,011
Ceded	<u>17,463,544</u>	<u>31,464,024</u>	<u>17,140,956</u>	<u>(17,385,645)</u>	<u>(37,624,154)</u>
Net	\$ 5,781,888	\$ 10,349,255	\$ 5,702,100	\$ 5,745,370	\$ 11,748,001
Losses (net change) (Note 8)	1,852,000				
Loss expenses incurred (Note 9)	2,741,733	2,164,258	1,618,173	1,521,895	2,090,195
Guaranty funds written-off (Note 7)	594,419				
Other underwriting expenses incurred (Notes 10 & 15)	<u>8,991,830</u>	<u>10,289,437</u>	<u>7,146,261</u>	<u>4,185,188</u>	<u>6,187,920</u>
Total underwriting deductions	<u>\$ 19,961,870</u>	<u>\$ 22,802,950</u>	<u>\$ 14,466,534</u>	<u>\$ 11,452,453</u>	<u>\$ 20,026,116</u>
Net underwriting gain or (loss)	<u>\$(11,138,017)</u>	<u>\$ (8,251,875)</u>	<u>\$ (5,246,963)</u>	<u>\$ (2,198,576)</u>	<u>\$ (3,880,719)</u>
<u>Investment Income</u>					
Net investment income earned	\$ 340,628	\$ 582,401	\$ 403,055	\$ 407,627	\$ 574,917
Net realized capital gains or (losses)	<u>0</u>	<u>(4,425)</u>	<u>(14,396)</u>	<u>(2,917)</u>	<u>16,170</u>
Net investment gain (loss)	<u>\$ 340,628</u>	<u>\$ 577,976</u>	<u>\$ 388,659</u>	<u>\$ 404,710</u>	<u>\$ 591,087</u>
<u>Other income</u>					
Net gain or (loss) from agents' or Premium balances charged off	\$ (23,213)	\$ (58,443)	\$ 26,294	\$ 89,005	\$ 460,007
Finance and service charges not included in premiums	672,202	1,335,807	1,228,965	583,284	934,367
Aggregate write-ins for miscellaneous income:					
NSF fees/Misc. income	35,176	160,347	55,160	21,816	(44,517)
Equipment disposals	<u>0</u>	<u>0</u>	<u>(1,913)</u>	<u>(11,797)</u>	<u>0</u>
Total other income	<u>\$ 684,165</u>	<u>\$ 1,437,711</u>	<u>\$ 1,308,506</u>	<u>\$ 682,308</u>	<u>\$ 1,349,857</u>
Net income after dividends to policyholders but before federal And foreign income taxes	\$ (10,113,224)	\$ (6,236,188)	\$ (3,549,798)	\$ (1,111,558)	\$ (1,939,775)
Federal and foreign income taxes Incurred	<u>(1,108,935)</u>	<u>(2,142,729)</u>	<u>(759,996)</u>	<u>(768,972)</u>	<u>0</u>
NET INCOME	<u>\$ (9,004,289)</u>	<u>\$ (4,093,459)</u>	<u>\$ (2,789,802)</u>	<u>\$ (342,586)</u>	<u>\$ (1,939,775)</u>

**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTEGRAL PART THEREOF.**